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OVERSIGHT HEARINGS WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARINGS

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION AND TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

FEBRUARY 23; MARCH 9; AND MAY 17, 1989

PART I

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CONTENTS

OVERSIGHT HEARINGS WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Page

Hearings held on:
  February 23, 1989 1
  March 9, 1989 53
  May 17, 1989 185

TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

THURSDAY, FEBRUARY 23, 1989

Leahy, Hon. Patrick J., a U.S. Senator from Vermont, opening statement 1
Lugar, Hon. Richard G., a U.S. Senator from Indiana 2
  Prepared statement 4
Heflin, Hon. Howell, a U.S. Senator from Alabama 5
Gorton, Hon. Slade, a U.S. Senator from Washington 5
Daschle, Hon. Thomas A., a U.S. Senator from South Dakota 6
Bond, Hon. Christopher S. "Kit", a U.S. Senator from Missouri 7
Kerrey, Hon. J. Robert, a U.S. Senator from Nebraska 8
Harkin, Hon. Tom, a U.S. Senator from Iowa 9
Conrad, Hon. Kent, a U.S. Senator from North Dakota, prepared statement 10

CHRONOLOGICAL LIST OF WITNESSES

Fogel, Richard L., Assistant Comptroller General, General Government Division, U.S. General Accounting Office, Washington, DC, accompanied by Michael Burnett, Assistant Director, General Government Division, and Cecile Trop, Assistant Director, General Government Division 10
  Potential for Futures Market Trade Practice Abuses, summary of statement 17
  Prepared statement 18
  Chart I—Potential Trade Practice Abuses 23
  Chart II—Potential Trade Practice Abuses—continued 24
  Chart III—Volume of Contracts Traded 25
  Chart IV—Number of Floor Participants Sanctioned 26
  Chart V—Amount of Fines 27
  Chart VI—Disciplinary Actions 28
Appendix 51

TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

THURSDAY, MARCH 9, 1989

Leahy, Hon. Patrick J., a U.S. Senator from Vermont, opening statement 53
Clark, Gerald F., senior vice president, government relations, New York Stock Exchange, Inc., letter of, dated March 7, 1989, to Thomas C. Bittman, Audit Manager, U.S. General Accounting Office, New York, NY, with an attachment, Exhibit B—NYSE Regulatory Expenses 59
Chart 1—Trading Volume vs. CFTC Staffing 60

Page
Chart 2—Contracts per CFTC Staff Year 61
Chart 3—CFTC Enforcement Division 62
Chart 4—CFTC Trading and Markets Division—Contract Markets Section: Budgets and Staff 63
Chart 5—Exchange Compliance Staffs 64
Lugar, Hon. Richard G., a U.S. Senator from Indiana 65
McConnell, Hon. Mitch, a U.S. Senator from Kentucky, prepared statement 66
Gorton, Hon. Slade, a U.S. Senator from Washington, prepared statement 67

CHRONOLOGICAL LIST OF WITNESSES

Gramm, Wendy L., Chairman, Commodity Futures Trading Commission, Washington, DC, accompanied by Andrea Corcoran, Director, Division of Trading and Markets and Dennis Klejna, Director, Division of Enforcement. 68
  Prepared statement 73
  Appendix A—Monetary Sanctions Imposed by Exchanges for Trade Practice Violations, 1986-1988 83
  Letter of, dated March 7, 1989, to Senator Patrick Leahy, Chairman, materials responsive to the questions posed in February 9, 1989, letter... 83
  CME Rule 515 92
  COMEX Rule 93
  NYMEX Rule 94
  Why is there the discrepancy between the Board of Trade and the Mercantile Exchange in dollar amounts 106
  Electronic Trading Systems 112
Leahy, Hon. Patrick J., letter of, dated March 14, 1989, to Hon. Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, questions submitted for the record by Senator Lugar 115
Questions submitted by Senator Lugar 115
"Violations Abound at New York Commodity Exchanges," March 1, 1989, Wall Street Journal article 115
Responses to questions submitted by Senator Lugar 117
Response to Judge Aspen's statements at Sanders' sentencing hearing, question submitted by Senator Kerrey 132
Gramm, Wendy L., Chairman, Commodity Futures Trading Commission, letter of, dated March 7, 1989, to Hon. Thomas A. Daschle, response to question concerning the authority of the Commission to conduct undercover investigations 133
Response to Senator Daschle's questions 148
Proposals 158
Leahy, Hon. Patrick J., closing statement 159
Gramm, Wendy L., Chairman, Commodity Futures Trading Commission, letter of, dated April 25, 1989, to Hon. Patrick J. Leahy, Chairman, to comment on various proposals designed to tighten oversight of floor trading 160

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Eret, Don, Dorchester, NE, letter of, dated March 4, 1989, to Hon. Patrick J. Leahy, statement for the record 181
Knight-Ridder, KRF Spotlight: CME's Committee Choices Raise Self-Policing Doubts, by Laurie A. Morse, March 2, 1989, article referred to by Senator Bond on page 126 of the hearing 182

TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

WEDNESDAY, MAY 17, 1989

Leahy, Hon. Patrick J., a U.S. Senator from Vermont, opening statement 185
Futures Volume Highlights—1988 in Comparison With 1987 187
Monetary Sanctions Imposed by Exchanges for Trade Practice Violations, 1986-1988 188
GAO Disciplinary Actions 189
Exchange Compliance Staffs 190
Lugar, Hon. Richard G., a U.S. Senator from Indiana, prepared statement 191
Conrad, Hon. Kent, a U.S. Senator from North Dakota, prepared statement 192

Page
Kerrey, Hon. J. Robert, a U.S. Senator from Nebraska 219
  Prepared statement 192
  Letter of, dated April 7, 1989, to Hon. Richard Thornburgh, Attorney General of the United States 193
  Civil Monetary Penalties—Schedule E: Collections referred to the Department of Justice as of September 30, 1988 193
  CFTC—Civil Monetary Penalties 195
Boschwitz, Hon. Rudy, a U.S. Senator from Minnesota 230
  Prepared statement 195

CHRONOLOGICAL LIST OF WITNESSES

Melamed, Leo, Chairman, Executive Committee, and Special Counsel to the Board of Governors, Chicago Mercantile Exchange, Chicago, IL 196
  Prepared statement 246
  Report of the Chicago Mercantile Exchange, Special Committee to Review Trading Practices to the Board of Governors, Wednesday, April 19, 1989 255
  Table of contents 257
Mahlmann, Karsten, Chairman, Chicago Board of Trade, Chicago, IL 198
  Chicago Board of Trade—1988 Disciplinary Case Profile 297
  Update—Enhancements to the Chicago Board of Trade—Surveillance and Compliance System 298
  Supplemental Submission Before the Senate Committee on Agriculture, Nutrition, and Forestry:
    Table of contents 302
    Executive summary 303
    The exchange 308
    Foreign competition 310
    Oversight and enforcement 312
    The Federal investigation 317
    Approved market enhancements 318
    Conclusion 328
    Appendix 1—Foreign competition tables 330
    Appendix 2—Broker trading (CFTC submission) 338
    Table of contents 339
    Appendix 3—1987 and 1988 disciplinary action summary 438
Guttman, Z. Lou, Chairman of the Board of Directors, New York Mercantile Exchange, New York, NY 201
Fink, Robert E., First Vice-Chairman, Commodity Exchange, Inc., New York, NY 204
  Prepared material (profile) 442
  Disciplinary sanctions, 1984–1988 for violations arising from trading activity 443
  Brody, Alan J., president and chief executive officer, COMEX, letter of, dated April 28, 1989, to Ms. Andrea M. Corcoran, Director, Division of Trading and Markets, Commodity Futures Trading Commission, written in response for requested information on the subjects of the exchange's audit trail program and dual trading in connection with a review of these issues 444
  Appendix A—Monetary sanctions imposed by exchanges for trade practice violations, 1986–1988 457
  Exchange Compliance Staffs 458
  Members of Commodity Exchange, Inc. Special Advisory Panel 459
"Probe of 2 Exchanges Shows Wild Fraternity of Traders in Yen Pit," the Wall Street Journal, January 26, 1989, by Scott McMurray and John Koten, staff reporters of the Wall Street Journal 215
Fine collection rate information:
  Beyer, Gerald D., letter of, dated June 16, 1989, to Ms. Christine Sarcone, information Senator Kerrey requested during hearing, enclosures 220
  Chicago Mercantile Exchange 221
  Chicago Board of Trade 222
  New York Mercantile Exchange 222
  Commodity Exchange, Inc 223
Valukas, Anton R., United States Attorney, U.S. Department of Justice, letter of, dated November 21, 1988, to Thomas Donovan, Chairman, Chicago Board of Trade, re: *United States* v. *Thompson B. Sanders*, 88 CR 104 225
Penalties imposed by type of case 235

Page
Leahy, Hon. Patrick J., closing remarks 243

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Questions submitted by Senator Leahy 461
Questions submitted by Senator Conrad 462
Questions submitted by Senator Bond 462
Composition of the Chicago Mercantile Exchange Board of Governors 462
Chicago Mercantile Exchange responses to questions submitted:
  Response to Senator Leahy 463
  Response to Senator Conrad 464
  Response to Senator Bond 465
Leahy, Hon. Patrick J., letter of, dated June 15, 1989, to Karsten Mahlmann, Chairman, Chicago Board of Trade, regarding a misimpression of testimony. 466
Mahlmann, Karsten, Chairman of the Board, Chicago Board of Trade, letter of, dated June 8, 1989, regarding two apparent misstatements 466
Response to Senator Leahy 467
Response to Senator Conrad 470
Response to Senator Bond 473
Appendix to responses:
  1988 Disciplinary Action for Trade Practice Matters 475
  1988 Disciplinary Action for Other Matters 477
  1988 Disciplinary Action on Other Matters 477
  1987 Disciplinary Action on Trade Practice Matters 478
  1987 Disciplinary Action on Other Matters 479
  CBOT Disciplinary Sanctions 480
Guttman, Z. Lou, Chairman of the Board of Directors, New York Mercantile Exchange, letter of, dated June 8, 1989, to Hon. Patrick J. Leahy, responses to additional questions 480
Response to Senator Leahy 480
Response to Senator Conrad 483
Fink, Robert E., First Vice Chairman, Commodity Exchange, Inc., letter of, dated June 8, 1989, to Ms. Betsy Paul, Hearing Clerk, responses to additional questions 484
Response to Senator Leahy 485
Response to Senator Conrad 486

OVERSIGHT HEARINGS WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Trading Practices in the Commodity Futures Markets

THURSDAY, FEBRUARY 23, 1989

U.S. Senate,
Committee on Agriculture, Nutrition, and Forestry,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Heflin, Harkin, Conrad, Daschle, Baucus, Kerrey, Lugar, Bond, and Gorton.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The Chairman. Good morning.

Today, we hold our first oversight hearing of 1989 on the Commodity Futures Trading Commission. This CFTC reauthorization year opens under some rather unusual circumstances. Congress and the public have been scrutinizing futures trading closely for a long while now, particularly since the stock market crash of October 19, 1987. Earlier this year, the reported criminal probe of the Chicago futures exchanges placed renewed attention on the integrity of floor trading practices.

The Chicago reports have raised deep public concerns about how well our futures markets are policed. This committee is responsible for assuring the integrity of those markets and we will see that this job is done. As a former prosecutor, I do not want to interfere with or prejudge the outcome of the investigation. But if laws have been broken, then violators must be prosecuted and punished accordingly—including being jailed, where appropriate.

No one has yet been indicted in Chicago, and it is far too early to presume the guilt or innocence of any persons or institutions. Even as the investigation goes forward, however, we have a responsibility to get the facts and resolve some key questions before we reauthorize the CFTC.

One, is there, in fact, widespread fraud on the floors of our major futures exchanges?

Two, if so, is this the result of weaknesses in the regulatory structure now in place, or failures in enforcement?

Three, are our systems adequate to detect trading abuses that are occurring or may occur in the future?

Fourth, did any regulator—be it a self-regulatory organization or the CFTC—fall down on the job?

I think these are questions other Senators are asking and certainly the public is asking. We will try to get the answers.

Some of these questions will doubtlessly be answered by the unfolding of the Chicago probe. Others can be answered now. Over the coming months, this committee will conduct a systematic review of the effectiveness of futures regulation at all levels. We will proceed along several fronts.

First, we have asked GAO to expand its examination of futures trading to cover all markets and to focus on such floor practices as dual trading; the role of brokers and broker associations; and the adequacy of exchange floor monitoring, compliance, and disciplinary programs.

Second, the CFTC will provide detailed data on its regulatory program, and Chairman Gramm will appear before us next month to testify on the CFTC's rule enforcement effort, its rule enforcement oversight reports, and other matters.

Third, we have had continuing contact with market users and with the exchanges to monitor their concerns. The Chicago exchanges are considering significant internal reforms. We are reviewing their actions with the help of GAO and will analyze any new proposals once the exchanges have reached their decisions.

Fourth, with appropriate care not to disrupt an ongoing investigation, we are monitoring the criminal probe in Chicago. We have asked the relevant agencies to keep us informed of events and to brief us at appropriate times.

Last summer, we asked GAO to examine futures trading with an eye toward the CFTC reauthorization. At that time, though the focus was primarily on issues raised by the 1987 stock crash, we also asked the GAO to review the operation of exchange and CFTC enforcement programs and the role of exchange audit trails in detecting trading violations. When the reports of the FBI investigation surfaced last month, we asked GAO to zero in on the ability of current regulatory systems to prevent abuses on the exchange floors.

I want to say at the outset the GAO has done a great deal of hard work under extraordinarily tight deadlines that we have imposed, and I appreciate that. The report today should be illuminating and highly useful.

Mr. Fogel and your colleagues, we thank you and look forward to your testimony. Before I go to you I want to yield to the distinguished Senator from Indiana.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator Lugar. Thank you very much, Mr. Chairman. I would like to submit my statement for the record and make just a summary comment, apropos of the comments that you have made at the outset.

The CHAIRMAN. Without objection.

Senator LUGAR. As you have often pointed out, Mr. Chairman, very generously, the two of us commenced consideration of many of these issues about 11 years go when we were more junior members of this committee, and, in my case, as the subcommittee chairman during two of the recent reauthorization efforts. The whole structure of CFTC and the futures markets has been a subject of very great interest to both of us.

I suppose I make that personal comment because the difficulties that now arise strike such a personal note in terms of assurances we have been given from time to time by members of the industry, that they were fully capable of handling the problems of audits and enforcement mechanisms for the industry.

The jury is still out on that; and of course, one of the reasons for oversight will be to see how well the industry people have done relative to how well the CFTC has done. But as I recall the bidding, CFTC on each prior occasion asked for substantially greater enforcement powers, and an audit system that was a good bit tighter.

I think the record ought to indicate that the CFTC has sought from this committee more powers than it has obtained from the committee, or from the Congress, as we finally rationalized these things through two Houses and through the conferences.

And so, on this occasion, it seems to me that we will be paying special attention to the nature of the abuses; both the alleged abuses and ones that may be known. They may fall within problem areas that are highly technical, as I am certain the witnesses today will get into it.

Within the spread of the bid and asked price, manipulation can occur that is not easily observable with the open outcry system. To begin with, questions will be raised as to how one gets to an audit trail at all, or could get to one, with trading that is not entirely electronically controlled.

If the whole audit system depends upon the actors and their recording of precisely what they do, and the time and the sequence of all of this, the spreads and so forth, it may be that we are dealing with a situation that we had not contemplated. It may be that no one is at fault except those who have manipulated the markets and the public trust within it. But it may be that we are looking at substantial changes in the way all of this ought to be governed.

So I make these points as one who has followed the bidding in this thing for at least 12 years. And I look forward, as I know you do, Mr. Chairman, to being intensely involved in bringing a much greater level of confidence to the markets by the time we have concluded our reauthorization effort on this occasion.

I don't start from a premise that the futures markets should be curbed or curtailed. I think that the structure Congress has given, and the CFTC has helped to bring about, has helped to build an enormously important and profitable industry employing many, many talented Americans.

I suppose my own sense of loss is that there are a few persons at the margins who are prepared to jeopardize all of this; that, I think, is highly regrettable. And I would agree with you, Mr.

Chairman, they ought to be prosecuted and put in jail. But beyond that, there has to be public confidence in something that I believe will grow. This is an industry in which America leads the world and it is very important we maintain that leadership. Without confidence in our futures markets, that leadership is in jeopardy.

Thank you, Mr. Chairman.

[The prepared statement of Senator Lugar follows:]

PREPARED STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Good morning Mr. Chairman. I would like to welcome our guests from the General Accounting Office and express my eagerness to hear what they have to say about trading practices at the commodities futures exchanges that they have been reviewing at the request of this committee.

Let me compliment you on the early scheduling of this hearing. As far as futures trading is concerned, the rumor mill is now in high gear. There has already been a shaking of confidence in our futures trading system and there is great potential for serious damage to occur if the facts of the matter are not brought out on the table very soon.

Enough information is not yet available for me to conclude what the problems are on our futures exchange floors, whether or not our regulatory system failed or performed, or what changes need to be made in the statute, the regulations, or at the exchanges or the CFTC as a result of the investigation in Chicago. I am eager to have a complete review of all potential problems and proposed solutions, but think that we need to approach this matter in an analytical fashion before we jump to any conclusions.

Mr. Chairman, as you know, I have been actively involved in commodity futures trading issues as a member of this committee from my first days in the Senate. As a matter of fact, as junior members of the Subcommittee on Agricultural Research and General Legislation back in 1977 and 1978, you and I both became deeply immersed in the 1978 reauthorization of the CFTC.

During subsequent reauthorizations of that act in 1982 and 1986, as the chairman of that subcommittee, I led the committee's efforts to refine the statutory framework that defines the current balance of regulatory controls between exchange self-regulation and the CFTC.

On January 19, 1989, a new chapter began with the first news article revealing the extensive FBI investigation of the Chicago futures exchanges. Since then, we have been barraged with news reports—allegations—about widespread trading abuses by brokers and traders on the exchange floors, but very little factual—or maybe I should say corroborated—information about the findings of the investigation.

Since the story first broke, the chairman and I have attempted to find out what we can about the allegations. We met with the Chairman of the CFTC, Wendy Gramm, but found that, because of constraints imposed on the agency in deference to the criminal justice system, she could not comment on even very general questions concerning the nature of the activity being investigated, the role played by the CFTC in the investigation, or whether the current regulatory system had done its job in Chicago.

Next, we sought information from the Attorney General himself, pointing out that we appreciate the need to maintain confidentiality of specific information to protect the criminal justice process, but expressing the need for this committee to have at least basic information concerning the operation of the regulatory process in this matter. Again, no information at all was provided or offered to be provided to this committee.

The Commodity Exchange Act is due to be reauthorized this year, and I am pleased that we have the GAO to turn to at this time to begin the process of examining trading practices and regulatory controls at futures exchanges under the current statutory framework. In my opinion, one of the biggest mistakes that can be made now will be for Congress to legislate hasty solutions to "regulatory problems" only to find out after the fact that we missed the boat.

I welcome the efforts by some exchanges to evaluate trading practices and controls from within and certainly hope that they will share their findings with this committee as soon as possible. On the other hand, all involved need to be cautious about focusing in on solutions before all of the facts are on the table. More regulators; elimination of dual trading; accelerated computerization of trading; to name a few, may be changes that should be made, but I am not ready to commit to these or any other ideas until more is known about the performance of the current regulatory system in the context of the Chicago allegations.

I now look forward to hearing what the witnesses have to say and to working with GAO on this issue during the coming months as the committee pursues its responsibilities to examine the act and determine whether the controls in place now are adequate to assure investor protection and market confidence in our commodity exchanges.

Thank you Mr. Chairman.

The CHAIRMAN. Well, I can concur completely. I do remember those days—it seems so long ago—when you and I were both new members of this committee and sitting, I think, about 10 feet beyond where Mr. Fogel is at that end of the table. We were doing the hearings on reauthorization of the CFTC. I could not concur more with the distinguished Senator from Indiana that the important thing is to retain the confidence in the operation of these markets.

Futures markets are extraordinarily important to the economy of this country. To maintain confidence in them, we must also maintain their integrity. That is really what will be involved here. These markets are important and they have some very, very talented and scrupulously honest people within them.

We must make sure to establish integrity by being able to point out those who are not honest, those who try to misuse the nature of the system. We must make sure that such people can be spotted and removed.

Senator Heflin.

STATEMENT OF HON. HOWELL HEFLIN, A U.S. SENATOR FROM ALABAMA

Senator HEFLIN. Well, I don't have a prepared opening statement. Naturally, the American people are interested in this; and it may well be that there will be a good deal of timelag before we really know what the true story is.

A sting operation that has been well publicized—the details of it has not been known yet—and it may well be that until after some prosecutions take place will we really know whether they are real problems with it or whether what corrective action we may have to take.

In the meantime, of course, if there are corrections that should be, we certainly ought to be very careful about it—look at them; look and see about it—and I agree that those that are guilty ought to be prosecuted to the fullest extent of the law and that we ought to try to maintain integrity in this entire industry; because it serves a very vital purpose for farmers as well as other business people.

The CHAIRMAN. Thank you. Senator Gorton, did you have any statement you wanted to make?

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM WASHINGTON

Senator GORTON. I did not come here with a prepared opening statement, Mr. Chairman. I must say, I do not automatically agree with everything which has been stated previously. Probably by reason of that, I must tell the members of the committee, I have questions as to whether or not we need two separate regulatory agencies with respect to securities. I am not convinced that we do.

What we have seen happen so far here has shown that the present system certainly creates the ability for people to manipulate it and to cheat at it. It is fine and wonderful to say that when we catch the guilty, we ought to put them in jail. But our responsibility is to try to see to it that we have a system which is less susceptible to being manipulated.

And so I question whether or not we ought to allow people to be trading on our own accounts while they are operating as agents for others. And it will have to be proven to me by those who advocate that system that it isn't something which is constantly going to be manipulated, even after this particular sting is over.

And I have certain questions as to whether some of the kinds of things which are being traded on futures markets are appropriate for trading at all, or are an involvement in pure speculation rather than appropriately setting markets; both here and within the jurisdiction of another of these committees.

I think what we have here from the GAO is going to be very, very important; but is only going to be the beginning of any appropriate inquiry on the part of this committee.

The CHAIRMAN. Senator Daschle.

STATEMENT OF HON. THOMAS A. DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. Mr. Chairman, I would associate myself with the remarks of Senator Lugar. I share the concern expressed both by the Chairman and Senator Lugar with regard to the consequences of the hearing today and many of the issues that we will be addressing. I think that there are three points to be made as we begin here, very briefly.

First, that we are all on trial to a certain extent. I think that this committee and committees in the House also have a responsibility to examine whether we as legislators have exerted proper oversight and concern for the way in which CFTC and the markets have functioned.

Second, the CFTC itself, when Ms. Gramm was before this committee a year ago, we all emphasized to her the importance of her role in providing as tough an oversight responsibility and enforcing rules and regulations as is possible.

I think the point could be made that what we have seen with regard to recent reports of FBI involvement in the markets in Chicago could also have been made with markets in New York or Paris or London or Tokyo. It isn't simply a function of futures markets. It could be something that could have easily happened in other markets as well.

Senator Lugar's comment that we are destroying a system on the basis of the actions of a few is a very pertinent point to be made here; that the vast majority of people here are well-intentioned, very honest people providing a service that is critical.

The last point to be made is probably the most important; it is that we have suffered a lack of confidence as a result of the revelations; and we have to restore that confidence. We have to restore it through adequate oversight. We have to restore it with an enforcement on the part of the CFTC that we may not have seen to the degree that we would like. And we may have to restore it with additional action on the part of the Congress itself as we reexamine the reauthorization of the CFTC.

So we have our work cut out for us; but the bottom line is we have a very important function here that serves a very important service that has to be addressed through the adequate oversight of the CFTC, through the adequate work done on the committees here in the Congress, and certainly through a restoration of the confidence of those investors; especially our farmers and livestock producers who view this whole affair with a great deal of dismay and concern about the prospects of having this service available to them in the future.

The CHAIRMAN. Senator Bond.

STATEMENT OF HON. CHRISTOPHER S. "KIT" BOND, A U.S. SENATOR FROM MISSOURI

Senator BOND. Thank you very much, Mr. Chairman. I wish to commend both you and Senator Lugar for having laid the groundwork for this morning's hearing.

Although many in Congress have been monitoring the U.S. financial markets very closely since October of 1987—it has become a rather widespread sport—our two leaders on this committee have had the foresight to request inquiries immediately following the disclosure of alleged improprieties in some of the Nations futures exchanges. Today, I look forward to hearing about the report prepared by the General Accounting Office.

Mr. Chairman, I have the unique privilege of serving both on the Banking and Agriculture Committees which sometimes convinces me that there can be too much of a good thing. But we have been looking at many of the regulatory issues——

The CHAIRMAN. And we honor your service.

Senator BOND [continuing]. And I am certainly looking forward to joining you as we work on the reauthorization of the CFTC. I think it is crucial that we work with the exchanges and the regulators to maintain confidence in the structure of futures markets, as several have already pointed out.

To date, Members of Congress have resisted the urge to call for massive regulatory reforms or drastic surgery. I support that cautious attitude and would hope it continues throughout the inquiries of the committees reviewing the current practices.

If it becomes apparent that reforms are necessary, I believe they should be given priority status and implemented as soon as possible. In recent weeks, there has been much speculation about the need for reform. We have read about the alleged improprieties, the dual trading, curb trading, price changing, and brokers associations.

We cannot be sure that all the loopholes have been closed; but we can require the very highest standards, both for surveillance and enforcement.

In 1960, approximately 3.9 million futures contracts were traded in the United States. In 1988, that figure grew to more than 245 million contracts. As these futures markets continue to expand in their scope, I think it is very important that we ensure that the regulatory component remain one step ahead. In other words, we have to anticipate the changes; not simply react to them.

In closing, I wish to thank the General Accounting Office for providing us with this report; and we look forward to hearing their conclusions.

The CHAIRMAN. Thank you very much, Senator Bond. Senator Kerrey, then Senator Harkin. Senator Kerrey.

STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Am I now in the right position?

The CHAIRMAN. Mr. Kerrey, as far as I am concerned, the day you came on this committee, you were in the right position. [Laughter.]

Senator KERREY. Well, Mr. Chairman, I would also applaud your and Senator Lugar's efforts to bring forth some individuals who can help us understand a bit about what is going on on these trading floors.

I say that because I have a great deal of respect for the difficulty of regulating human behavior in any way; and I think that difficulty is made worse by our ignorance. And in this particular case, I must confess to a considerable amount of ignorance; although I have been on the floor a number of times—I understand the terms; I can speak the language as if I am very proficient in trading—I would not want to be put in a position where my life depended either on my ability to predict where the market is going to go or to survive on the floor itself.

And so, as a consequence, I find myself sitting here on the threshold of making decisions about regulating the behavior of individuals that are doing things that I don't understand at all; let alone comprehended what it is they are doing wrong.

I share the concern many have already expressed that the negative behavior that threatens the marketplace itself has been greeted with great suspicion. I would point out two aspects that concern me:

First, both the Chicago Merc and the Board of Trade provide enormous liquidity to the marketplace—liquidity that is needed. If we were to take drastic action, for example, to eliminate both, the loss of that liquidity would have a devastating impact upon production agriculture—an enormously negative impact on production agriculture; one that we politicians, I think, would have a very, very difficult time trying to remedy.

The second thing that I would point out is that there are, I think, some actions on the part of the Government that cause the producers and the person on the street to be concerned.

For example, when the USDA lost 1½ million acres of corn, and then reported that they found 1½ million acres of corn—and the market dropped the limit 2 straight days on corn—I heard from farmers that said, essentially, "What the hell is going on here?"

When USDA reports that we have 99.5 million head of cattle, and the market drops the limit a couple days in a row—not as a consequence of measuring that we are under 100 million head, a relatively low volume, but based upon the expectation that the number is going to be different than that—again the producers out there lose confidence that the Chicago Mercantile Exchange and the Board of Trade are doing a good job.

I point these things out only to illustrate that as we focus our attention on what is going on on the floor, there are other things inside of government that have a very negative impact upon the producer out there and cause them to lose confidence in the marketplace itself.

Again, I associate myself with the remarks made by Senator Lugar. I am disappointed that I got here too late, Senator Leahy, to hear all of your remarks. I am sure it would have been impressive as well. [Laughter.]

The **Chairman**. It is not required that members agree with the chairman on anything, although it is appreciated. [Laughter.]

Senator **Daschle**. Could we hear them again, Mr. Chairman? [Laughter.]

The **Chairman**. On those rare chances when it occurs, it is appreciated. Senator Harkin.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA

Senator **Harkin**. Thank you, Mr. Chairman. I, too, want to thank you and Senator Lugar for getting this hearing together and looking at this issue. I want to thank GAO for being here.

I would just say that it is certainly too early to reach any final conclusions about the alleged trading violations. I don't think we have enough information for that. So I look forward to hearing the testimony from GAO today.

I think what has been reported thus far does indeed raise very serious questions about certain practices on the floors of the Chicago exchanges. So it behooves this committee to examine these questions thoroughly; both as a part of the CFTC reauthorization this year and to fulfill our oversight responsibilities to protect investors and to ensure the integrity of the markets.

My chief concern is that improper practices of brokers on the exchange floors can cause significant financial losses to their customers, such as farmers and country elevators, who rely on the futures markets to reduce their price risks through hedging.

In addition, I think it is important that public confidence in the integrity of the exchanges be restored and maintained. The Chicago exchanges perform an important and useful risk management function in the commodity and financial markets. Public confidence is essential for the futures market to operate effectively and efficiently.

For example, the recent reports could cause farmers to avoid using the futures markets for hedging; thus placing them at a greater risk of losses from price to clients. So this committee has an important responsibility to help in restoring and maintaining public confidence in the integrity of these markets.

Because of this importance of public confidence in the exchanges, I feel we must proceed carefully and deliberately in our examination of trading practices at the exchanges. We must insist that we get full and accurate information about these matters; and I think we must be careful not to rush to enact legislation that could unduly impair the functioning of the futures exchanges and, in fact, reduce their usefulness to those in agriculture and other industries who rely on them.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Now, taking this chance before anybody else shows up, we will go to the testimony.

I think what you have heard around the table is a general feeling of the concern Senators have on this issue. The concern, as Senator Harkin and others—Senator Daschle, Senator Kerrey, Senator Lugar, Senators Bond and Gorton—have pointed out, that these extremely important markets work well only if we can be guaranteed of their integrity. This is critical not only to our farmers but to the whole commercial makeup of the United States

For an outsider watching the trading, it seems like organized chaos or unorganized chaos, depending upon one's point of view. But futures trading is a highly complex form of dealing requiring experts. The public, those outside, require confidence in its integrity.

Without objection, the prepared statement of Senator Conrad will be made part of the record.

[The prepared statement of Senator Kent Conrad follows:]

PREPARED STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Thank you Chairman Leahy. I commend you for holding hearings on this important issue.

Literally tens of thousands of businesses and farmers depend on the futures markets to reduce the risk of doing business. Thousands more businessmen depend on the futures markets to determine market prices. Billions of dollars depend on the efficient and honest operation of the futures markets.

For decades, the markets have performed the essential role of reducing risk for businessmen—and they have done it relatively well.

When poor regulation or lax rules allow blatant illegality to take place, legitimate businessmen can lose millions of dollars. Just as important, the essential economic function of the futures markets is thwarted causing the loss of additional millions. Farmers and country elevators will be harmed.

It is not our role to investigate possible wrongdoing on the floor of the exchanges—that is properly the role of the FBI and the CFTC. Our job is to make sure that the Commodity Futures Trading Commission has the resources, the tools, and the will to make and enforce strict regulations that will prevent illegal trading.

The question we face is whether or not the CFTC regulations and enforcement activities have been adequate to prevent abuses. If the answer is no, then it is my belief that the Congress should pass detailed legislation to regulate the activities of the exchanges. Our goal must be to restore public confidence in the honest operation of the exchanges.

The CHAIRMAN. Mr. Fogel, it is over to you.

STATEMENT OF RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C., ACCOMPANIED BY MICHAEL BURNETT, ASSISTANT DIRECTOR, GENERAL GOVERNMENT DIVISION, AND CECILE TROP, ASSISTANT DIRECTOR, GENERAL GOVERNMENT DIVISION

Mr. FOGEL. Thank you, Mr. Chairman. I would like to introduce my colleagues, Cecile Trop and Mike Burnett, who are both Assistant Directors at GAO; and they have both been actively involved in looking at the markets for several years. We got very intimately involved with the markets as a result of the market crash and our followup work on that. As you said, we have been working with your committee and other committees in the Congress, to look at how well the market operations are being carried out.

As you and the other members noted, we are here today to discuss, in a preliminary sense, how the CFTC and the Chicago Mercantile Exchange and the Board of Trade oversee futures market practices. We don't know any more than you do about what has happened as a result of the FBI operations. We only know what we have read in the papers; and we are not in any position, therefore, to comment on the effectiveness of either the CFTC's oversight or that of the SRO's as it relates to those allegations.

But rather, what we thought would be useful today is to suggest an issue that the committee may wish to pursue with CFTC and the exchanges in your subsequent hearings to try to ensure that these regulators do provide adequate oversight. And the issue can be framed in this way: It is really the level or the intensity of CFTC and the exchanges' efforts to detect and sanction trading abuses. It is our belief that this knowledge, accompanied by an understanding of the ways the trading system can be abused, should help the committee decide what changes, if any, are needed in the trading system and oversight programs.

It is not easy to quantify the intensity of oversight efforts. Part of it, quite frankly, has to do with the attitude and, as you said, Senator Kerrey, the behavior of individuals on the exchanges. But we think that, to help you get a handle on this, there are three indicators that do provide some useful qualitative measures.

The first is the adequacy of the framework of controls CFTC and the exchanges have established; second is the number and nature of disciplinary actions taken on identified abuses; and third is the use of oversight results to improve the control system, target trends of abuse, and allocate scarce resources.

What I would like to do, Mr. Chairman, is summarize the rest of my statement and then let the full statement appear in the record; if that is all right.

The CHAIRMAN. Of course that is all right. I would urge those who are interested, though, to read the whole statement. It is long; it is complex. But it is excellent and people should read it.

Go ahead, Mr. Fogel.

Mr. FOGEL. Thank you. What we would like to do first—and we have two charts that you can just take a look at—is to describe the types of trade practice abuses that can occur [charts I and II]. As you mentioned, they include various techniques to avoid competitive order execution. That is the important thing to understand.

By avoiding competition, floor participants may secure a better transaction price than that available to other market participants, including customers and other traders. You can see from the charts the major abuses that CFTC and exchange officials look for.

Many of the definitions of these abuses overlap and, indeed, in instances that we are aware of, it is sometimes difficult to say whether a wash trade is, in fact, just that or if the wash trade may be related to some prearrangements that have been made or that type of thing—but just sort of going down the list, prearranged trading is defined as when traders agree to some aspect of a transaction before it is openly executed on the floor of the exchange.

Accommodation trading is when you are entering transactions to assist another floor participant in accomplishing an improper trading objective.

Trading ahead of customer orders is when you are trading for one's personal account or an account in which one has an interest while having in hand an executable customer order in that contract.

Bucketing is when there is a failure to introduce an order to the marketplace. And this traditionally occurs when a broker or a firm noncompetitively takes the other side of a customer's order.

Wash trading is when you enter or purport to enter into transactions to provide the appearance of trading activity without resulting in a change in market position.

Curb trading occurs when there is trading after the official close of trading.

Cuffing is delaying the filling of customer orders to benefit another member; and cross trading is matching customer orders without offering them competitively.

The CHAIRMAN. How does cross trading differ from prearranged trading?

Ms. TROP. In a prearranged trade, for example, we could agree off the exchange floor that we were going to take certain actions on the exchange floor which might involve any of these abuses. For example, the action could involve trading ahead of a customer order, or maybe I would do a wash trade first.

In the other case, the cross trading case, there is not necessarily an element of prearrangement. You have a customer order in hand and you want to match that with an order that you want to do for your own account or for somebody else's account, and you match the two orders in that way.

The CHAIRMAN. Thank you.

Mr. FOGEL. The systems that the exchanges have in place, relatively speaking, make it fairly easy to detect trading ahead of customer orders; and I will get into that a little bit later. But relatively speaking, the types of internal controls they have in place make it easier to detect that type of abuse than some of the others.

As Cecile said, a lot of the abuses that can occur have to occur when there is some agreement among traders to enter into some type of collusion. And that is one of the things that I think all of us are just going to have to await the outcome of the FBI investigation to see to what extent that is occurring; although you will see a little later on that the exchanges and the CFTC do try to identify some of those problems through the systems that they have.

And that leads me into a discussion of the type of framework of oversight controls that now exist. The Chicago Merc and the Board of Trade identify and investigate trade practice abuses through similar-type programs. They can be detected through internal sources, including reviewing trading information assembled in an audit trail, and observing trading floor activity.

They are also identified from external sources of information, including exchange member complaints, customer complaints, and

CFTC referrals. The most common source of all the mercantile exchange's leads is member and customer complaints.

These complaints were the source of 133 of the 164 investigations at the Merc in 1988. Comparable numbers were not available to us at this time from the Chicago Board of Trade; although all 16 of the Board of Trade's externally generated cases in 1988 came from members who saw there was some problem and reported that to the Board of Trade.

One of the most important sources of evidence that the exchanges use in supporting cases of trading practice abuse is their audit trail system. An audit trail system reconstructs trading activity by the time of trade. That is what I think Senator Lugar said was so important, and in our minds, too; that we have a system that has greatly improved since 1986. The idea, though, is we have sophisticated computer programs and everything else, but the system still relies on the accuracy of the people in the trading pits to record things properly.

Putting the trades in the order that they occur can help isolate questionable trades and detect and punish those involved in trading practice abuses. That is the key to understanding how the system works—to put the trades in the order that they can occur.

As you get into it and as you go on further in your hearings, and deal with the CFTC and the self-regulatory agencies, you will hear a lot of discussion about times—brackets within 30 minutes, within a minute; what happens within a minute's worth of trading—but a key part of the audit trail system is to have the trades listed in order.

All the CFTC-regulated exchanges are required to have an audit trail system that is integrated into the exchange's trade practice abuse oversight program.

Now, in 1986, CFTC amended those regulations to require that the exchanges determine trade execution times within one minute instead of within a 30-minute bracket. And the Merc and the Board of Trade worked together to develop a computerized trade reconstruction system that assigns times to each trade to meet this requirement.

At both exchanges, trade reconstruction may be imperfect because all times are imputed based on several data sources; and floor participants may intentionally or unintentionally make errors in recording and reporting such data.

Further, while CFTC requires that the imputed times be precise to the nearest minute, a single minute can include hundreds of trades, several of which could be made by a single floor participant. Each exchange has also developed computer systems to analyze audit trail data to detect or corroborate potential trade practice abuses. And they started using these systems in conjunction with this computerized audit trail last year; so they are just in the beginning stages, we think, of really understanding how you can use sophisticated computer programs to kick out various suspicious trades and identify what is going on.

An important feature of CFTC's oversight program of the exchange is to carry out its regulatory responsibilities or its rule enforcement reviews. The CFTC also examines disciplinary action notices and exchange investigative logs to monitor the number of the investigations conducted, the type of violations being investigated, the disposition, as well as the timeliness and adequacy of sanctions.

The CFTC also has its own trade practice surveillance program for reviewing audit trail data, observing the trading floor activity and investigating potential abuses.

When it finds that an exchange has failed to meet its obligation, the CFTC can, among other sanctions issue a cease and desist order directing the exchanges to improve their enforcement activities.

Obviously, in the end, if an exchange does not comply, the CFTC could pull its authority to operate as a contract market.

In September of 1988, the CFTC did a rule enforcement review of the Chicago Mercantile Exchange and concluded that it had an effective audit trail system and trade practice surveillance program. CFTC reported that the Merc had incorporated timing data into its computerized surveillance system, which enhanced its surveillance capabilities.

In an earlier June 1987 rule enforcement review of the Merc, CFTC also concluded that it maintained an effective trade practice surveillance program which, based on the information that was coming out of this system, initiated a significant number of internally generated investigations.

The CFTC recommended improvements, though, in both reports and the Merc responded positively to all those recommendations. However, the CFTC has not yet followed up to determine if all the promised actions have been taken, and whether they have been totally effective yet.

The CFTC has been more critical of the Board of Trade's audit trail system and trade practice surveillance program than it has been of the Mercantile Exchange's programs.

The CFTC included in its February 18, 1989, rule enforcement review report, which was just released this week, that the Board of Trade needed to improve its audit trail system. It recommended that the Board of Trade take several actions to improve the usefulness of the times that are put into this system in detecting and pursuing trading abuses.

We had an exit conference with the Board of Trade officials last week, and they told us that they believed these recommendations would be easy to implement, and they would take action quickly to do so.

In essence, what the CFTC found at the Board of Trade, and I am summarizing this, is that traders really were not diligent enough in following the procedures, and properly recording times on trades as they should have. My sense is, too, that the Board of Trade, based on the report, was not aggressive enough in making sure that the traders followed the practices.

These types of situations can be fixed. I mean, I personally do not view them as something that says there is something inherently wrong with the system, but it takes a commitment and a willingness to follow the procedure and report and do the things correctly.

Also, the Board of Trade, based on the CFTC report, probably was not aggressive enough in using information that it had in its computer systems to check on possible violations. The CFTC made a series of recommendations that the Board of Trade said it was going to implement to improve its ability to use the data in its system to try to identify potential problems.

Based on the types of activities that have occurred, I think there are several questions the committee ought to pursue with the CFTC and the exchanges. We are certainly willing to work with the committee, too, over the next several months to try to get some more answers.

The first one is, have CFTC and the exchanges adequately addressed the vulnerabilities of the trading systems and established appropriate controls? The dilemma is, as I think you all properly observed in the beginning, that it is going to be hard to answer this question completely until we know the results of the FBI investigation.

Another question, though, that can be asked is how do these oversight systems compare with those of other markets and other regulators?

A third question is: Is a 1-minute audit trail time standard sufficient to adequately ensure that customers are protected and that we have an open and competitive market?

Detecting abuse is only the first part of the process needed to minimize the number of abuses that occur. When potential abuses are investigated and abusers are identified, penalties must be timely and severe enough to act as a deterrent.

An exchange official told us that disciplinary action can vary by the type of offense or the existence of a prior disciplinary record. They also said that most investigations of trade practice abuses, regardless of source, are closed without action because the subject is innocent or evidence is insufficient.

Now, the next chart that we have, developed from data in the CFTC annual reports, just shows the volume of the number of contracts traded at both exchanges [chart III]. As you can see, although it was a very low volume in 1960, it has grown substantially between 1984 and 1988. These are volumes for all types of commodities that are traded on those exchanges.

This gives you some sense of a baseline in terms of numbers of contracts.

Our next bar chart [chart IV] developed from unaudited exchange-provided data shows the disciplinary actions for trading violations, and it shows that over the same time period the number of disciplinary actions for trading violations have increased at the Chicago Mercantile Exchange while remaining relatively constant at the Board of Trade.

As you can see, the number of Merc floor participants sanctioned for trade practice related violations increased from 13 to 105 in 1988, in contrast to the Board of Trade, where sanctions fluctuated between a low of 8 for trade practice abuses in 1985 to a high of 32 in 1986. In 1988, the Board of Trade sanctioned 13 floor participants.

The next bar chart [chart V] shows that between 1984 and 1988, the Mercantile Exchange's fines for trade practice abuse ranged from about $155,000 to a little over $1.7 million. Fines for all 5 years combined totaled about $3.6 million.

For the same period Board of Trade fines ranged from $65,000 to about $225,000, and fines for all 5 years combined were about $800,000.

This is the type of data that is basically what I would call baseline information. It does not necessarily say that one exchange is doing a better job than another, but it does start raising some questions that we believe need to be followed up with the exchanges in terms of what they do, what their criteria is for the types of fines, and that type of thing.

According to exchange officials, permanent expulsion or lengthy suspensions are more severe penalties than fines because they can deprive floor participants of their livelihood.

As you can see from the tables, the next chart [chart VI], between 1984 and 1988, the number of members expelled from both exchanges averaged about two a year, including eight expelled at the Mercantile Exchange in 1987. Suspensions at the Merc ranged from a low of 238 days in 1986 to a high of 12,487. We are comparing, a little bit, apples and oranges there, because the Merc officials told us that these suspensions represent a combination of business and calendar days, whereas at the Board of Trade the suspensions only relate to business days.

But, again, this is the type of data that needs to be developed and consistently available so the Congress and the regulators can track, over time, trends in how they are enforcing things.

In addition to the exchange action, CFTC may also take enforcement action, and from fiscal years 1986 through 1988, they initiated enforcement actions resulting in over $900,000 in civil fines and penalties, 35 cease and desist orders, 43 trade suspensions or revocations, and 31 registration suspensions or revocations.

The CHAIRMAN. The CFTC does not have the power to expel somebody from membership in an exchange, does it?

Mr. FOGEL. No, I do not believe that they do.

The CHAIRMAN. They only impose sanctions?

Mr. FOGEL. Right. They work, I think, through the exchanges.

The CHAIRMAN. One other point that sticks in my mind. The price of a seat on the Board of Trade and the Chicago Merc, they are roughly the same, are they not?

Mr. FOGEL. I think they are relatively close, yes, right.

The CHAIRMAN. I realize that they change over time, but they are in about the same ballpark.

Mr. FOGEL. Yes.

Among the questions that need answering to assess the adequacy of the oversight system results, number one: Is reliable data available to determine the universe of abuses that occur?

The exchanges and the CFTC have been very cooperative with us in trying to develop this information.

Two is: How do disciplinary actions in the futures markets compare to those taken in other financial markets?

Three: Do the penalties for abuses need to be applied more consistently or made more severe?

It is difficult to determine the adequacy of the oversight system's results because the universe of abuses is not known. Low numbers of investigations or disciplinary actions can either mean that the oversight system is working well because there is an effective deterrent, or that it needs revision because it is not finding abuses or punishing offenders severely enough.

As I said earlier, the final results of the FBI investigation may give all of us a better sense of where that is.

We are just beginning to evaluate how the agencies use their oversight information; but we have noted, for example, that certain information is not routinely aggregated for management's use.

For example, when we asked both the Board of Trade and Mercantile Exchange for summary statistics on the source of their investigations, each had to generate the summaries for us from their detailed investigative logs.

The Board of Trade told us that they had recently increased their budget by $1 million for computer system enhancements to detect trading abuses, and we will, of course, be looking at that.

The point I want to make is that in a lot of law enforcement activities, one of the things you have to do is some analyses of the types of abuses that are occurring, where they are occurring, and where you are finding out about them; and that leads you to put in different types of enforcement strategies.

One of the things we think is important for all SRO's and the CFTC, and indeed on the equity side too, is that they have an understanding of where the abuses are occurring and do some analyses so that they can develop good future strategies for ensuring the integrity of the markets.

That basically concludes our statement, Mr. Chairman. We would be pleased to answer questions.

[The prepared statement of Mr. Fogel follows:]

PREPARED STATEMENT OF RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT PROGRAMS, U.S. GENERAL ACCOUNTING OFFICE

POTENTIAL FOR FUTURES MARKET TRADE PRACTICE ABUSES—SUMMARY OF STATEMENT BY RICHARD L. FOGEL

In response to a request from the Honorable Patrick J. Leahy, Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, GAO provided its views on the potential for trade practices abuses at the Chicago Board of Trade and the Chicago Mercantile Exchange.

In Summary: GAO identified three indicators the committee may wish to pursue in judging the intensity of CFTC and the exchanges' efforts to detect and sanction trading abuses. These were the adequacy of the framework of controls established; the number and nature of disciplinary actions taken; and the use of oversight results to improve the control system, target trends of abuse, and allocate scarce resources.

How Adequate is the Framework of Oversight Controls?

The advent of a 1-minute trade timing standard and the subsequent enhancement of computerized audit trail and evaluation systems substantially enhanced CFTC and the exchanges' ability to detect and investigate trade practice abuses. CFTC needs to monitor these systems as they evolve and follow up to ensure that weaknesses are corrected. Key questions GAO suggested the committee pursue include whether CFTC and the exchanges adequately assessed trading system vulnerabilities and established appropriate controls, how these oversight systems compare with those of the other markets and regulators, and whether the 1-minute timing standard is sufficient.

What are the Numbers and Nature of Disciplinary Actions Taken?

It is difficult to determine the adequacy of an oversight system's result because the universe of abuse is unknown. Low numbers of investigations or disciplinary actions can either mean the system is an effective deterrent, or that it needs revision because it is not finding abuses or punishing offenders severely enough. Key questions GAO suggested the committee pursue include whether reliable data is available to determine the universe of abuses, how disciplinary actions taken compare to those taken in other markets, and whether penalties from abuses need to be applied more consistently or made more severe.

How can Oversight Information be Better Used?

CFTC and the exchanges could make good use of summary data from trading activity, investigations conducted, and penalties imposed to improve their oversight programs. GAO suggested the committee pursue whether CFTC and the exchanges have the information they need, and whether they use it to improve their oversight systems.

Prepared Statement

Mr. Chairman and members of the Committee:

We are pleased to appear today to discuss how the Commodity Futures Trading Commission (CFTC), the Chicago Mercantile Exchange (CME), and the Chicago Board of Trade (CBT) oversee futures market trading practices.

As you know, trading on these exchanges has been the subject of FBI undercover operations, the results of which are not yet public, but which have received much media attention alleging widespread trading abuses. CFTC officials told us that they can not comment on the extent of the agency's involvement in identifying or investigating the alleged abuses until after any indictments are issued. Therefore, we are not in a position now to comment on the effectiveness of CFTC oversight as related to these allegations.

Instead, our purpose today is to suggest an issue the committee may wish to pursue with CFTC and the exchanges in subsequent hearings, and to discuss the results of our preliminary work as it relates to that issue. The issue is the level or "intensity" of CFTC and the exchanges' efforts to detect and sanction trading abuses. This knowledge, accompanied by an understanding of the ways the trading system can be abused, should help the committee decide what changes, if any, are needed in the trading system and oversight programs.

It is not easy to quantify the intensity of oversight efforts. We have, however, identified three indicators that will provide useful qualitative measures. They are:

—the adequacy of the framework of controls CFTC and the exchanges have established,

—the number and nature of disciplinary actions taken on identified abuses, and

—the use of oversight results to improve the control system, target trends of abuse, and allocate scarce resources.

Individually, these indicators provide a perspective on key aspects of the oversight system. Collectively, they provide a basis for judging how serious CFTC and the exchanges are about detecting and sanctioning trading abuses.

HOW CAN THE OPEN-OUTCRY TRADING SYSTEM BE ABUSED?

The CME and CBT trade futures contracts through a competitive system called open-outcry, where floor participants verbally bid and offer orders to each other at centralized locations in the exchange called trading pits. Several types of trade practice abuses can occur in this trading system. The CFTC and exchanges monitor trading in an attempt to detect these abuses. Most of the abuses they try to detect are the same kind that media reports allege have been detected in the FBI operation.

Market characteristics may allow trade practice abuse

Several characteristics of open-outcry trading may allow floor participants to take advantage of customers:

—Futures prices can be volatile, and the same price may appear many times within a short timeframe or during a trading session. As a result, if a trade is executed within the price range occurring around the execution time reported, it will be more difficult to determine the execution price that the customer should have received.

—The large number of participants in a pit—in the hundreds for active futures contracts—makes floor surveillance for trade practice abuse more difficult.

—The exchanges rely on market participants to properly report their trading activity. Dishonest participants, particularly those acting in collusion, can falsify trading records in an attempt to conceal abuses.

A variety of trade practice abuses can occur

Trade practice abuses include various techniques to avoid competitive order execution. By avoiding competition, floor participants may secure a better transaction price than that available to other market participants, including customers and other traders. You can see from the charts the major abuses that CFTC and exchange officials look for. (See charts I and II.) As I explain these, note that some of the definitions may partially overlap.

—Prearranged trading: agreeing to some aspect of a transaction before it is openly executed on the exchange floor.
—Accommodation trading: entering transactions to assist another floor participant in accomplishing improper trading objectives.
—Trading ahead of customer orders: trading for one's personal account or an account in which one has an interest, while having in hand any executable customer order in that contract.
— Bucketing: failure to introduce an order to the marketplace, traditionally occurring when a broker or firm noncompetitively takes the other side of a customer order.
—Wash trading: entering or purporting to enter into transactions to provide the appearance of trading activity without resulting in a change in market position.
—Curb trading: trading after the official close of trading.
—Cuffing: delaying the filling of customer orders to benefit another member.
—Cross trading: matching customer orders without offering them competitively.

Case study

To illustrate how cheating can occur and how customers are harmed, let me describe a case that CBT discovered and prosecuted.

In April 1985, CBT disciplined three exchange members—A, B, and C—for systematically cheating on customer spread orders. They executed trades among themselves at prices better than those available to other market participants. Spread trading is a strategy which involves, in this case, simultaneously purchasing one delivery month of one commodity and selling that same delivery month of a different commodity. The expectation underlying the strategy is that the price relationship between the two commodities will subsequently change and yield a profit. Consequently, it is to the customer's advantage for the trades to be simultaneously executed at the cheapest buying price and highest selling price.

In this case, member A received a customer spread order to buy 160,000 bushels of July wheat and sell 160,000 bushels of July corn at the prevailing market prices. One of many subsequent rule violations occurred when member A disclosed this order to member C, and as an accommodation to her, for her personal account, prearranged to sell the July corn segment of the customer spread at a price lower than that at which July corn was trading at the time. Member C benefited because she bought below the market price and presumably sold at the market price, realizing a gain. The customer lost the exact amount she gained. Trades executed among members A, B, and C elicited a member complaint and CBT launched an investigation.

The investigation, which reconstructed the members' trading activities, found that the three members were systematically prearranging trades on customer spread orders. In addition, they failed to report the trades as spreads as required by CBT rules, and they traded corn in the wheat pit. The CBT fined the members $50,000 each and permanently barred them from exchange membership and from employment or association with any exchange member firm. The CBT concluded that the members had violated numerous exchange rules, including prearranged trading, failure to competitively offer the orders by open-outcry, failure to designate the orders as spreads, accommodation trading, taking the other side of a customer order, trading outside of the designated commodity pit, and compromising the integrity of the exchange.

HOW ADEQUATE IS THE FRAMEWORK OF OVERSIGHT CONTROLS?

CFTC regulations give the exchanges primary responsibility for identifying, pursuing, and prosecuting trade practice abusers. The CFTC is responsible under the Commodity Exchange Act for ensuring the exchanges carry out their responsibility. It attempts to do so without interfering with efficient market operations.

CME and CBT programs

The CME and CBT identify and investigate trade practice abuses through similar programs. Abuses are detected through internal sources, including reviewing trade information assembled in an audit trail and observing trading floor activity. Abuses are also identified from external sources of information, including exchange member complaints, customer complaints, and CFTC referrals.

The most common source of all CME leads is member and customer complaints. These complaints were the source for 133 of the 164 investigations at CME in 1988.

Although comparable numbers were unavailable from CBT, all 16 of CBT's externally generated cases in 1988 came from members.

One of the most important sources of evidence that the exchanges use in supporting cases of trade practice abuse is their audit trail system. An audit trail system reconstructs trading activity by time of trade. Putting the trades in the order that they occur can help to isolate questionable trades, and detect and punish those involved in trade practice abuses. All CFTC regulated exchanges are required to have an audit trail system that is integrated into the exchanges' trade practice oversight program.

In 1986, CFTC amended its audit trail regulations to require that the exchanges determine trade execution times within 1 minute instead of within a 30-minute bracket. The CME and CBT worked together to develop a Computerized Trade Reconstruction (CTR) system that assigns times to each trade to meet this requirement. At both exchanges trade reconstruction may be imperfect because all times are imputed based on several data sources, and floor participants may intentionally or unintentionally make errors in recording and reporting such data. Further, while CFTC requires that CTR-imputed times be precise to the nearest minute, a single minute may include hundreds of trades, several of which could be made by a single floor participant.

Each exchange also has developed computer systems to analyze audit trail data to detect, or corroborate potential trade practice abuses. The exchanges started to use these systems in conjunction with CTR data last year.

CFTC programs

An important feature of CFTC's oversight program for ensuring that the exchanges carry out their regulatory responsibilities is rule enforcement reviews. In addition, CFTC examines disciplinary action notices and exchange investigative logs to monitor the number of investigations, conducted, types of violations being investigated and their disposition, as well as the timeliness and adequacy of sanctions. The CFTC also has its own trade practice surveillance program for reviewing audit trail data, observing trading floor activity, and investigating potential abuses. When CFTC finds that an exchange has failed to meet its obligation to enforce exchange rules, it can, among other sanctions, issue a cease and desist order directing the exchange to improve its enforcement activity. If the exchange does not comply with the order, it could lose its authority to operate as a contract market.

Rule enforcement reviews enable CFTC to evaluate how effectively exchanges' trade practice surveillance and disciplinary programs detect and prosecute possible rule violations. They also determine how well the exchanges have implemented previous recommendations.

The CFTC recently reported on rule enforcement reviews at CME and CBT.

In a September 1988 CME rule enforcement review, CFTC concluded that CME has an effective CTR system and trade practice surveillance program. The CFTC report stated that CME had incorporated CTR timing data into its computerized surveillance system, which had enhanced CME's surveillance capabilities.

In a June 1987 CME rule enforcement review report, CFTC concluded that CME maintained an effective trade practice surveillance program which initiated a significant number of internally generated investigations.

The CFTC recommended improvements in both reports and CME responded positively to all the recommendations. The CFTC has not yet followed up to determine if promised actions were taken.

The CFTC was more critical of CBT's CTR system and trade practice surveillance program than it was of CME's. The CFTC concluded in its February 1989 rule enforcement review report that CBT needed to improve its CTR system. It recommended that CBT take several actions to improve the usefulness of CTR times in detecting and prosecuting trading abuses. CBT officials told us these recommendations will be easy to implement and they will take action quickly.

In a September 1986 CBT rule enforcement review report, CFTC concluded that CBT had effective procedures for dealing with potential trade practice abuses initiated through complaints or referrals. However, CFTC made several recommendations for improvements, including expanding the coverage of routine surveillance to provide greater emphasis on internally detected trade practice abuses and internally initiated investigations; modifying the criteria employed in the internal surveillance program so that potential abuses would not be overlooked; ensuring that investigations were thorough; and completing inquiries in a more timely fashion.

The CBT responded by stating that it would implement the recommendations. However, CFTC's February 1989 rule enforcement review report stated that although some improvements have been made, inquiries were still taking too long, and too few disciplinary actions resulted from internally generated investigations. CBT officials said they have made progress in these areas since the September 1986 rule enforcement review, and will continue to do so.

Observations

Among the questions the committee may want to pursue concerning oversight structure are:

—Have CFTC and the exchanges adequately assessed the vulnerabilities of the trading systems and established appropriate controls?

—How do these oversight systems compare with those of other markets and regulators?

—Is a 1-minute audit trail time standard sufficient?

The advent of the 1-minute standard in 1986, and the subsequent development of computerized audit trail and evaluation systems at CFTC and the exchanges substantially enhanced their ability to detect and investigate trade practice abuses. Because the systems are new, the process for improving them is evolving.

Similarly, the two recent rule enforcement reviews at CBT and CME are CFTC's first public evaluation of these systems. While we have not yet evaluated the timeliness or thoroughness of CFTC's review process, some of the weaknesses CFTC identified, if corrected, should help better detect trade practice abuses. Thus, CFTC needs to follow up to ensure that the weaknesses identified are corrected.

WHAT ARE THE NUMBER AND NATURE OF DISCIPLINARY ACTIONS TAKEN?

Detecting abuse is only the first part of the process needed to minimize the number of abuses that occur. When potential abuses are investigated and the abusers are identified, the penalties must be timely and severe enough to act as a deterrent.

Exchange officials told us that disciplinary action can vary by the type of offense or the existence of a prior disciplinary record. Often this results in different disciplinary actions for what appears to be the same offense. They also said that most investigations of trade practice abuse, regardless of source, are closed without action because the subject is innocent, or evidence is insufficient.

Our first bar chart, developed from data in CFTC annual reports, shows the total trading volume by number of contracts at both exchanges. (See chart III.) Volume has been higher each year at CBT.

Our second bar chart, developed from unaudited exchange-provided data, shows that disciplinary actions for trading violations have increased at CME and remained relatively constant at CBT. (See chart IV.) As you can see, from 1984 to 1988, the number of CME floor participants sanctioned for trade practice-related violations increased from 13 in 1984 to 105 in 1988. In contrast, the number of CBT sanctions fluctuated between a low of 8 in 1985, to a high of 32 in 1986. In 1988, CBT sanctioned 13 floor participants.

Our third bar chart shows that, between 1984 and 1988, CME fines for trade practice abuses ranged from about $155,000 to a little over $1.7 million. (See chart V.) Fines for all 5 years combined totaled about $3.6 million. For the same period, comparable CBT fines ranged from about $65,000 to about $225,000. Fines for all 5 years combined were about $811,000.

According to exchange officials, permanent expulsion or lengthy suspensions are even more severe penalties than fines because they deprive floor participants of their livelihood. As you can see from the tables, between 1984 and 1988, the number of members expelled on both exchanges averaged about two a year, including 8 expelled at CME in 1987. (See chart VI.) Suspensions at CME ranged from a low of 238 days in 1986 to a high of 12,392 in 1987. CME officials told us these suspensions represent a combination of business and calendar days. Therefore, the data are not comparable to CBT data. At CBT, suspensions were a low of 55 business days in 1984 and a high of 5,587 in 1986.

In addition to these exchange actions, CFTC may also take enforcement action. For fiscal years 1986 through 1988, CFTC initiated enforcement actions resulting in over $900,000 in civil penalties, 35 cease and desist orders, 43 trading suspensions or revocations, and 31 registration suspensions or revocations.

Observations

Among the questions that need answering to assess the adequacy of oversight system results are:

—Is reliable data available to determine the universe of abuses that occur?

—How do disciplinary actions taken in the futures market compare to those taken in other financial markets?

—Do penalties for abuses need to be applied more consistently or made more severe?

It is difficult to determine the adequacy of an oversight system's results because the universe of abuses is not known. Low numbers of investigations or disciplinary actions can either mean that the oversight system is working well because it is an effective deterrent or that the oversight system needs revision because it is not finding abuses or punishing offenders severely enough. The final results of the FBI investigation may provide a better idea of the types of abuses occurring, and should be an important indicator of the effectiveness of the current oversight system.

HOW CAN USE OF OVERSIGHT INFORMATION BE BETTER USED?

We are just beginning our work to evaluate how the agencies use their oversight information. We have noted, however, that certain information is not routinely aggregated for management's use. For example, when we asked CBT and CME for summary statistics on the sources of their investigations, each had to generate the summaries for us from their detailed investigation logs.

CBT officials told us they have recently increased their budget by $1 million for computer system enhancements to detect trading abuses. We will be looking at system enhancements at CFTC and the exchanges in more detail later.

Observations

The question to consider on the use of oversight information is broad:

—Do CFTC and the exchanges have the information they need, and do they organize and use the information available to improve their control systems, target patterns of abuse, and allocate scarce resources?

The answer is important because it seems to us that the CFTC and exchanges could make good use of summary data from trading activity, investigations conducted, and penalties imposed to improve their oversight programs. For example, by evaluating the frequency and types of member complaints, CFTC and the exchanges could improve their computer systems' capability to identify the trading abuses that led to those complaints.

CONCLUSIONS

We have not completed sufficient work to reach conclusions about CFTC and exchange efforts to detect and sanction trading abuses. In light of recent events, CFTC and the exchanges are reexamining aspects of the open-outcry trading method and their surveillance systems to determine whether additional changes are needed to make abuses more difficult to perpetrate and easier to detect. As you have requested, we will continue to monitor these efforts and to assess what needs to be done.

Mr. Chairman, this concludes my prepared statement. We will be pleased to answer questions.

[Charts I–VI follow:]

CHART I

GAO

Potential Trade Practice Abuses

- Prearranged trading
- Accomodation trading
- Trading ahead of customer orders
- Bucketing

CHART II

GAO

Potential Trade Practice Abuses (cont.)

- Wash trading
- Curb trading
- Cuffing
- Cross trading

CHART III

GAO Volume of Contracts Traded

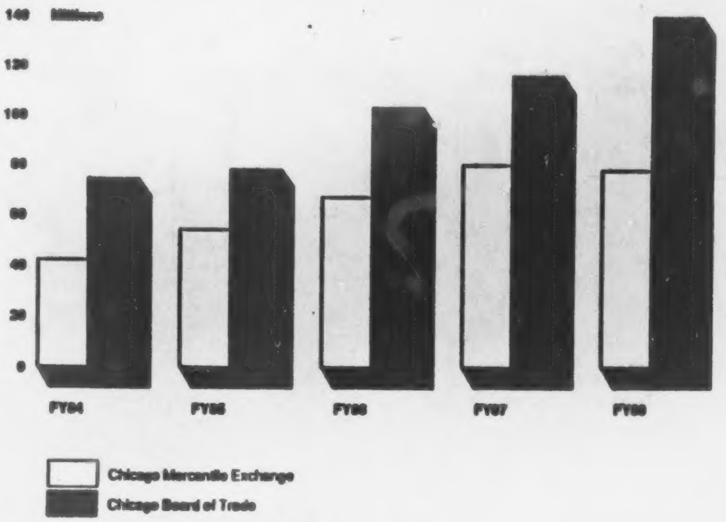

CHART IV

GAO

Number of Floor Participants Sanctioned

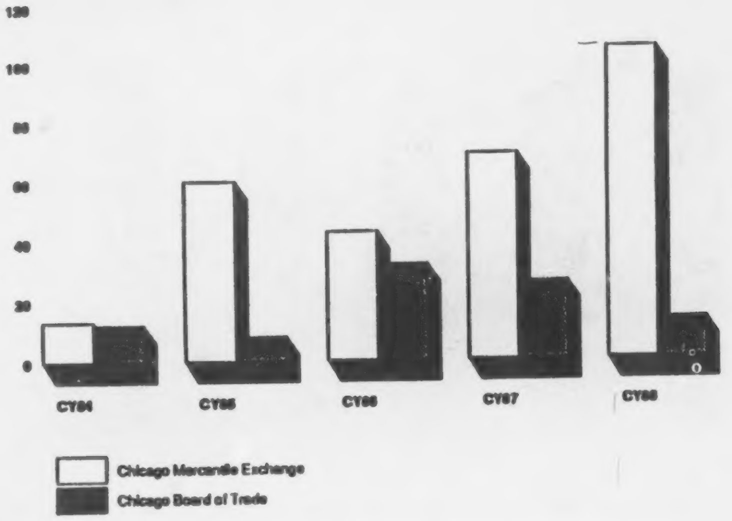

CHART V

GAO Amount of Fines

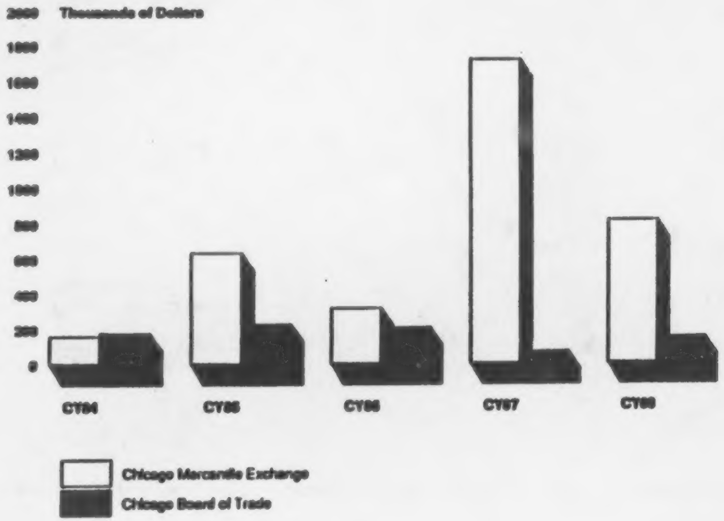

CHART VI

GAO Disciplinary Actions

The Chicago Mercantile Exchange	**CY84**	**CY85**	**CY86**	**CY87**	**CY88**
Floor Participants Sanctioned	13	60	43	69	106
Fines	$155,275	$830,600	$313,900	$1,718,675	$911,250
Expulsions	1	1	0	8	2
Suspensions (Bus./Cal. days)	570	6,368	236	12,392	6,110

The Chicago Board of Trade					
Floor Participants Sanctioned	12	8	32	26	13
Fines	$175,000	$225,000	$203,200	$94,800	$143,900
Expulsions	4	2	3	1	0
Suspensions (Business days)	55	539	5,587	196	4,330

The CHAIRMAN. Thank you.

I suspect there will be some questions, and let me ask a couple to start off.

In your statement, and especially as laid out in your charts, you raise the question of whether the CFTC and the exchanges have pursued their rule enforcement programs with sufficient intensity, and, as I understand the testimony and the charts, you measure intensity by such factors as the framework of controls in place, the number of disciplinary actions taken, and the use of oversight data to improve those controls.

Of course, each of those points raises questions about current futures regulation. Now, based on your work so far, do you see sufficient reason to doubt the intensity of current rule enforcement efforts either at the exchanges or at the CFTC?

Mr. FOGEL. Well, let me start first with the CFTC. I think we are generally pleased with the frequency of the CFTC's rule enforcement reviews—the fact that they cover all of the activities that they appear to have covered in the last several years. They have also taken more aggressive action to require the exchanges to develop better audit trail systems.

One of the things that concerns us a little bit is that the CFTC, to the best of our knowledge at this point in time, does not have a lot of documentation behind the rule enforcement reviews. So, if someone like us wants to go in and review the adequacy of the data the CFTC used to reach its conclusions, we have to work directly with the exchange to pull it out. I think we would like to see a little more documentation and workpapers.

Overall, we are not displeased with the extent to which they are monitoring the exchanges, and we are satisfied, like I said, that in 1986, they took some important aggressive action to get the exchanges to improve their monitoring.

The CHAIRMAN. Well, what about the exchanges?

Mr. FOGEL. I think, too, based on our work to date we would feel there has certainly been a commitment at the exchanges to develop the systems that can allow them to adequately police their markets.

The question of the extent to which they are really committed to using the systems aggressively to do that is something that I do not think we are prepared at this point to answer completely. We've certainly seen progress, and I think it is easier for an outsider to come in and sort of criticize them for maybe not doing everything that they could.

I think that one thing that may be indicative, though, of the extent to which they are committed is the aggressiveness with which they implement the recommendations that the CFTC has made.

If you go back and look at some of the rule enforcement reviews, there were several instances where the CFTC in early reviews said the Board of Trade was not investigating cases quickly enough and doing some other things. They went back in a year and a half, 2 years later, and they still were not doing that. There is a question in the Merc on a couple of things, too. So, I do not think we are prepared to say today one way or another how aggressively the exchanges are really committed to using the tools they have available. I think we have certainly seen progress on both exchanges.

The CHAIRMAN. Well, let us break this down to some of its components. When we had the last CFTC reauthorization back in 1986, we debated at length the CFTC's proposal for new exchange audit trail systems designed to detect trading abuses. Senator Lugar discussed those debates earlier. I understand these audit trail systems are largely in place now.

How would you rate the quality of floor policing today compared to what we had prior to 1986?

Mr. FOGEL. I guess my sense is it is sort of like getting into the latter part of the 20th century, instead of maybe back in—this is a little hyperbole—back in the early part of the century. I do not think there is any comparison.

As Senator Lugar said, you are dealing with a system here where you have to do the best you can to try to get good information on all these trades, and all you have to do is go back and look at the chart on the volume of contracts [chart III] that are traded now, and you cannot do that without the computer system.

One of the significant things that therefore occurred was the 1986 change in the commitment of the exchanges to very quickly get that system onboard, and anyone who has been involved in developing systems knows that those are not easy things to do. You have software problems and hardware problems. So, I think you have to give them a lot of credit for moving in the last couple of years to develop a much better audit trail system. That does not mean they are perfect yet, but I think you have to give them a lot of credit.

The CHAIRMAN. Well, I want to understand, even with these new computerized systems, what basically are the most difficult abuses for either the exchange or CFTC officials to detect if they are taking place?

Mr. FOGEL. Well, if you go back and look, the computer systems are going to track the trades that occurred, who made them, at what price, when.

That is not going to really tell you whether there was some prearranged trading, whether a couple of traders got together off the floor and said, hey, let us try to work this deal. That is not going to tell you directly whether there were some accommodations made.

What the audit trail system can do, though, is provide a lot of data, and you can start looking at trends. For example, if you notice that there are a series of trades among two or three brokers, and they are constantly trading among themselves, and there is not a lot of price spread, you can develop software that kicks that type of data out, that then enables you to do more investigations. In fact, both exchanges have systems that are doing that; and, in our sense, they are becoming more sophisticated at that.

The computer system can fairly easily track whether a broker is trading ahead of a customer, again, if the times are recorded accurately, because you could see whether it is the trade for the customer or if he is trading for his own account. Again, over time, you can have systems that kick out information that can allow you to do more analyses.

The CHAIRMAN. The CFTC, when they did their rule reviews, said that the audit trail systems could time trades to the nearest minute in about 85 percent of the cases at the Chicago Merc, and in an undetermined proportion of cases at the Board of Trade.

At the Board of Trade, this accuracy, they said, was complicated by problems in timing spread trades and CTI–3 trades and a large number of out-of-sequence trading cards. You said earlier today that an awful lot can take place even during that 1-minute interval.

But I read those statistics to mean that the systems do not generate reliable trade times for at least 15 percent of the trades on the Chicago Merc, and an equally significant number on the Board of Trade.

I want to know how big a hole these audit trail inaccuracies create. You have talked about the software. The exchange might look at a couple of traders going back and forth, but can somebody say, "Well, all right, there is this 15 percent hole. Could I, as a trader, go down there and just fit myself into that 15 percent, especially if I am acting in collusion with somebody else"?

Mr. FOGEL. Right.

The CHAIRMAN. Could I do that and be pretty sure that I will avoid being caught?

Mr. FOGEL. That is definitely a hole in both exchanges.

The CHAIRMAN. Tell me why.

Mr. FOGEL. Well, most of the trades in the unverified category were executed by members for their own accounts, or for members trading on the floor.

The one important thing is they generally did not include trades where one side was a customer order, but it goes back to what you said. If brokers are trying to conceal the cheating of customers, they are aware that the exchange will know when a customer order arrives at the floor, and when it was executed, so there is less of an incentive to do it there.

But when they are trading among their own accounts, if they want to do some manipulation of the price and they are not as aggressive at recording that, which they are not, it is more difficult to have the audit trail system detect potential abuses.

So, I think you hit it when you said what the problem is. The key, too, is in the Board of Trades last rule enforcement review by the CFTC which pointed out they do not have an adequate system to effectively verify the time of trades even when they are recorded.

The CHAIRMAN. Can these systems get up to 98, or 99, or 100 percent accuracy so that nobody could find an error window to operate in?

Mr. FOGEL. I do not think you can ever get any system that is going to be failsafe to the 99 percent accuracy and make it, in this type of operation, a cost-efficient, cost-effective system. You could get there, but the question would be, what price would you have to pay in terms of the efficiency of the markets?

I think there are other things that could be done. There are things that are being explored about trying to figure out electronic ways to record the times, but I want to emphasize this again——

The CHAIRMAN. Like using a sort of electronic notebook?

Mr. FOGEL. That is right. That you could do.

But one of the vulnerabilities still in both markets is the high percentage of unverified trades executed by members for their own accounts or for members when they are trading for their own accounts or for other members on the floor.

Ms. TROP. Could I just jump in here? I would like to make the point that for the 85 percent where the trades are verifiable at the Chicago Mercantile Exchange, you can still hide trading abuses in that category.

Also, for those other, somewhat less than 15 percent as it turns out because you have to account for out-trades at the Chicago Mercantile Exchange, just because those trades are not verifiable does not mean that they are not accurate. You just cannot verify their accuracy.

The CHAIRMAN. I understand. I must admit that with some of my instincts as a prosecutor, I am trying to figure out where I would look for misconduct. I am looking to see where there might be a window. I do not mean to suggest——

Mr. FOGEL. That is one of the areas.

The CHAIRMAN. I am not going to suggest that because there are 15 percent of trades that you might have trouble examining, that those are all illegal by any means.

Your data for 1988 shows that the two Chicago exchanges took disciplinary actions against 105 and 13 floor participants respectively. Now, these are not the totals of all sanctions, are they? They are only a portion.

Mr. FOGEL. No, these are just disciplinary actions for trade practices.

The CHAIRMAN. If there are about 3,000 or 3,500 seats each on the two exchanges then the number penalized would be for the Merc, about 3 percent of the total, and for the Board of Trade, about one-half of 1 percent. Is that approximately right?

Mr. FOGEL. Right, that is correct.

The CHAIRMAN. Are you surprised at these levels of sanctions? Do they appear high? Low? About right?

Mr. FOGEL. I cannot give an answer to that, because this is the first time we are able to develop any baseline data. I think the type of question that came to my mind on the trend is why it seemed to be going up fairly significantly over this 5-year period at the Mercantile Exchange, and it has stayed relatively constant at the Board of Trade; but I do not think that we can draw any conclusions from the numbers themselves.

I just want to say one other thing. I miss——

The CHAIRMAN. Is one exchange being more aggressive than the other? I am just thinking that everybody writing the story on this hearing is going to have an obvious question when they look at these charts. The charts give the impression that the Merc is more aggressive than the Board of Trade. Is that accurate or——

Mr. FOGEL. We cannot say. I think if people are writing stories, they need to go ask the exchanges what the trends mean.

I think that is one of the issues that we would like to help you get into over the next several months. We just have not had time yet to go behind these to find out why the trends are the way they are.

The CHAIRMAN. Well, I have been stepping over onto my colleagues' time here, and I apologize. I have a whole series of questions now. Either I will get to them later today or I will submit them in writing. Here is just one last question.

The CFTC, and this is basically a hearing on them, is responsible for supervising the exchanges. Is the CFTC being aggressive enough in forcing the exchanges to make improvements?

Do they have enough tools to be aggressive?

Mr. FOGEL. I think, like I said earlier, we are pleased with the rule enforcement reviews. My own sense is that from a GAO standpoint we would always like to see people be a little more aggressive, in the scope of the investigation, how adequately they follow up, how they report; but our sense is that CFTC has increased its effectiveness in these areas in the last couple of years.

One thing I did misspeak on earlier: The CFTC can revoke trading privileges and registrants directly itself, based on what it can do.

We do not have any indication from the people that we have talked to, either at the CFTC or the exchanges that they do not feel that they have the tools available today to do the job—or the regulations.

The CHAIRMAN. I see.

Thank you.

Senator Lugar.

Senator LUGAR. Thank you very much, Mr. Chairman.

I was intrigued by your response to Senator Leahy's question as to how you compare the post-1986 situation with 1-minute reporting to the 30-minute blocks prior to that. You characterized the change as a difference of two centuries.

The irony of our predicament now is that if there are problems, and there obviously are—FBI is investigating them—how in the world there would have been any trail with the 30-minute situation before and all the trades that occurred?

You know, clearly the argument in 1986 with the exchanges was that the CFTC wanted a tight audit trail. It argued for something really substantially tighter than the 1-minute situation that we have now. I think in fairness to the agency that needs to be recognized.

Mr. FOGEL. That is correct.

Senator LUGAR. The industry, I think it is fair to say, argued that this was a lot of bother and raised a lot of problems, for reasons that we are now discussing. For people in the trading pits to be recording all of this activity, particularly with the escalation in trading that is represented on the charts that you have seen it could be quite a problem. I suppose I am amazed that 85 percent of these trades actually got recorded. I presume roughly correctly, although we really do not know.

Mr. FOGEL. Right.

Senator LUGAR. Now, you are asking people in the middle of the high-paced ballgame to be recording every minute all their activity, and sometimes they get it right and sometimes they forget about it, or they are just overcome by events.

But that is the audit trail on which you are depending, and, as Senator Leahy has elicited from you, there are gaps. For instance, at least 15 percent of trades are not accurately reported. Amazing, given the volume as many were reported, and we just have to guess at the accuracy or the sequence of the reporting, even those that get down——

Mr. **Fogel**. That is correct.

Senator **Lugar** [continuing]. Are reasonably correct.

Now, let me, though, lead you through two hypothetical situations: one, involves prearranged trading. Just for sake of argument, broker A gets a customer order, and you have pointed out that that sort of rings a gong——

Mr. **Fogel**. Right.

Senator **Lugar** [continuing]. A customer order as opposed to insider trading, to sell at the market price, which is now ranging between $8.98 and $9.02, for example.

Based on, however, a preset deal, broker A sells to broker B at $8.98, then broker B immediately sells the contract back to the market for $9.01 or $9.02, for a profit of 3 or 4 cents. A and B split the gain, and since all the prices are within the trading range, nobody knows that they have been traded. On paper all is proper, even a perfect audit trail finds nothing wrong here.

I make that point, not to ask you a question but simply to say that even if everybody recorded all this, and they have it right, if they had prearranged it in that fashion, there is no trail. The customer got cheated.

Now, I do not know what the FBI is now looking at, but I have a hunch that this is one of the sorts of things that they are looking at.

Mr. **Fogel**. That is——

Senator **Lugar**. Mainly, that you have a prearrangement of people who are professionals. They know the audit trail is there. Somehow, however, the customer lost 3 or 4 cents in this situation and did not know about it.

Mr. **Fogel**. Yes, that is correct, and that is what I was trying to explain earlier, too. The audit trail system is not going to be able to detect everything. If you are going to prearrange something, you might do that off the floor, or you might do it with signals on the floor, or who knows how you are going to do that.

The audit trail system cannot pick up everything.

Senator **Lugar**. Now, another situation, so-called price changing, and it is called other names, broker A buys a contract for $10, reports the price to the customer, however, at $10.02, and keeps the change.

An audit could catch the discrepancy, but if both the actual and reported prices are within the trading range, no one may ever know how to look, or where to look into this situation.

I make that point and the previous one to suggest, as Senator Leahy asked, is CFTC being aggressive? You responded "Fairly much so. We always like to see more."

I suppose the point I am trying to establish is even if they were very aggressive with regard to the audit trail and everybody got it all down right, and the system as we now have it was perfectly executed, it is very conceivable that the customer in both of these instances could have been cheated.

Now, this leads, I suppose, to a question that maybe the FBI investigation will be helpful in answering. Namely, to what extent should the CFTC or the exchanges go into some degree of counterintelligence? This is what I think is implied, with prearrangement and with other human factors involved, in order to detect price changing or what-have-you.

I do not know how to divine the motives, the conversations, except maybe as has been done with the FBI; to record the actual voices or conversations in the pits of people——

Mr. FOGEL. Yes.

Senator LUGAR [continuing]. That the audit trail clearly could not pick up, but that only some type of countersurveillance—really electronic spying——

Mr. FOGEL. Yes.

Senator LUGAR [continuing]. Could get into.

I must say it is fair to say this committee or the CFTC, or the exchanges, may not have been as vigilant in oversight as we should have been. We may be becoming more sophisticated all the time, but I suppose I am asking of you, as someone looking into this from the perspective of the public interest and public policy, does our oversight in this case really go so far as to suggest that the policies that ought to be adopted would have included electronic spying, and wiring of persons?

If we do not have an audit trail which physically picks this up in the manner that we are now doing, is there any way to pick it up without really having all participants wired for sound or some other intrusive mechanism which gets into motivation and prearrangement?

Mr. FOGEL. I would like to defer a complete answer until we have an understanding of what the FBI found, but I do not personally think you would want to have a system where everyone is wired for sound and you are recording everything they are doing. That really gets to a question of whether you are having efficient markets and the behavior of people, and how much you can track that.

I do think, though, that——

Senator LUGAR. Is there any way, though, to avoid the cheating that I pointed out? How does the customer not lose his 3 or 4 cents?

Mr. FOGEL. We are aware of a couple of cases where big customers were watching the screens, and let us say they thought they were buying something at $10, and the broker said, no, you bought it $10.02; and they were watching the screen, and they knew that something was going on and they may have made a complaint and said, "Wait a minute. We think we were getting cheated on that."

Senator LUGAR. The large customer who is in a position to do this——

Mr. FOGEL. May be able to catch that. Now, generally what they would do is just pull their account and go ahead with someone else.

But I think there might be a way through, as Senator Leahy suggested, and there is some testing being done of this now through some electronic recording of when trades occur, which would not be too intrusive on the traders to do something, but I do not think that you could ever guarantee in any market operation, you know, total safety, if you really want that. That is not, maybe, the place to put your money.

There is always going to be some people who are going to be trying to cheat and that is why you need Sting operations and prosecutors to root out that fraud, and then prosecute the people and if they are guilty put them in jail or fine them very substantially.

Senator **Lugar**. There has been some discussion at the exchanges, as you know, that in trading after hours or in the international markets, that all this would be done electronically. That apparently orders would be executed in a way that does not have the open outcry system, which would occur during the days.

Mr. **Fogel**. Yes.

Senator **Lugar**. Likewise, there could have been a considerable number of thoughts by exchange members that the so-called dual trading ought to be abolished.

Is it not fair to say that if you did it all electronically, and if you eliminated the dual trading system, that a very large number of potential abuses that we have been discussing would be dissipated at that point?

Mr. **Fogel**. A lot of abuses that we have now may dissipate. Others could arise, based on the electronic tradings. I guess my answer is that any system we develop is going to be vulnerable to some type of abuse.

Senator **Lugar**. I appreciate your answer because I have raised the question deliberately. I think the committee will have to examine carefully the electronic trading system.

Now, the exchanges say, as you do, that a lot of potential abuses may be the unintended consequence of electronic trading. You know, in the same way that last time they objected to tightening the audit trail. However, I think we need to consider a system that is better and finally squeezes the possibility for fraud and abuse down. Perhaps if we go for an electronic system and eliminate dual trading to cure whatever problem we think is there now, maybe other things would arise. If so, we would like your help in identifying those.

Mr. **Fogel**. Well, we would be glad to do that, yes.

Senator **Lugar**. Fairly early on, so we know where the reforms are likely to lead. I must say I am attracted to the thought because we now have a system in which there are so many trades occurring, and so many more potentially will occur, if the exchanges continue to grow.

The technology of this thing is going to have to catch up with the clearly dynamic advances that are being made there. I am not certain that I see, given the current audit trail business and the recording of all of this, that it is going to make it, even by the next reauthorization.

So, it seems to me that a significant technical change will have to occur, and in doing that we had better be advised as best as we can by all the experts of what the unintended of consequences may be of the reform.

Mr. **Fogel**. I agree with that completely, Senator, and one point I would like to stress, and this is based on the work we did in the market crash and the work we have done looking at the savings and loan crisis and everything else—it is critical that the regulator, in this case the CFTC, have the capacity in terms of the quality of staff, the numbers of people, to understand what is going on in those exchanges, to be able to adequately assess the computer systems and everything else. If the regulators do not have the capacity, we in the government and the public are going to be in trouble. That is one of the problems we have had in the savings and loan crisis, and when we were in the market crash work last year one of the things that concerned us there, not so much with the CFTC but with the SEC is they didn't have, for example, we think, adequate computer capacity within the agency to understand what was going on in the equity markets; and, as we were in the futures markets here, that you have to make sure, and I think ask the CFTC and make sure that they have the capacity to adequately regulate.

I would certainly take with a grain of salt industry arguments that we do not need a good audit trail system and we should not track things closely. I just do not think that we can afford for the integrity of this system to buy that argument today.

Senator LUGAR. I agree. I believe the industry people need to know that the confidence of the American people in all of this is of the essence. They are not going to have much of an industry unless we have that.

Mr. FOGEL. That is right.

Senator LUGAR. We really have to get that point clear. There is a lot to all of these changes, technologically, but there is a lot of money to be made if you have dynamic new trades.

Mr. FOGEL. That is right.

Senator LUGAR. And the volume is increasing. That is the tradeoff that has to be anticipated.

I hope we are going to have full cooperation from the industry; but, in any event, I appreciate very much your testimony and your following through these hypothetical questions with me.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I have for the record a prepared statement by Senator Conrad. [1]

Senator Daschle, did you have questions?

Senator DASCHLE. Thank you, Mr. Chairman.

I appreciate, Mr. Fogel, your comments in response to the questions already asked, and I commend you for the kind of dedication you have certainly shown of the issue thus far.

As I look at this whole thing, I see three functions: The first is detection, the second is enforcement, and the third is the willingness to apply disciplinary action.

I have a question with regard to each.

With regard to detection, you have already made it clear to the committee that audit trail alone is not enough if we are going to deal with each one of the abuses that your charts outline at the beginning.

What I do not have clear in my mind is the degree to which other detection actions may be required and how the detection actions in the CFTC compare with those in the SEC.You laid that out as a question in the beginning: Do we do as good a job in the CFTC as they are doing now in the SEC?

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[1] See page 10 for Senator Conrad's prepared statement.

Could you enlighten us a little bit more with regard to our ability to detect? Are those at the SEC doing things that the CFTC are not doing as far as the detection of abuse at this point?

Mr. **Fogel.** Well, they are dealing with a different type of market, obviously, in the way they do things. When we drafted this statement, I asked the staff, are we setting up a job for ourselves to compare the way the SEC and the CFTC worked? And the answer was yes.

So, rather than answer it in detail, I think that I would like to say that we are willing to compare that. They are looking at different things. Even in both types of markets, you need statistical information. The New York Stock Exchange has what they call a "stock watch system," where they gather a lot of information on who is trading, and a lot of it is to try to get at insider trading and identify who is doing things.

But even there you have to rely sometimes on informants, other brokers, or customers to come forward. In the futures market, there are people in the pits observing what is going on, although I must say having been down there too I do not know how they observe everything that is going on. They obviously know a lot about that.

But we would be glad to do that study for you. I would not want to compare today how the two operate, though.

Senator **Daschle.** Mr. Chairman, I think it would be very helpful if at some point we could get an analysis of the comparative detection methods used and the degree to which the CFTC sizes up to the SEC in their respective responsibilities.

With regard to the number of different abuses that you listed on your charts [charts I and II], it may not be a fair measure by which to judge detection, but could you elaborate a little bit more with regard, even perhaps to the percentage of the abuses that you listed there, that can actually be detected by audit trail?

In other words, would you say that the vast majority of abuses that you have outlined here can be detected?

Senator Lugar obviously pointed out two areas that cannot be.

Mr. **Fogel.** Yes.

Senator **Daschle.** But I do not have a good enough sense as to the degree of success that audit trail has brought to detection given the array of abuses that obviously exist.

Mr. **Fogel.** Let me just start down, and then let Cecile or Mike jump in with more elaboration on that.

The rule enforcement reviews by the CFTC have shown that—and this is their conclusion—that the system at the Mercantile Exchange has been a little more effective at detecting problems than has the system at the Board of Trade. But at both exchanges the conclusion is that the systems can detect it, and I would like to let Cecile or Mike explain in a little more detail the types of things they can detect.

Ms. **Trop.** I guess I would answer your question by saying all of the things that were listed up there, except for cuffing——

Senator **Daschle.** Except for?

Ms. Trop. Except for cuffing where you are withholding a customer's order from the floor—I'm sorry, curb trading, where you are trading after the close of business, with the exception of curb trading, the systems that analyze the audit trail data could, but not necessarily will, detect all the other kinds of abuse.

I would say to Senator Lugar that even for the two types of abuses you mentioned those could be detected, the second one not by the audit trail system but by other kinds of oversight actions that the CFTC takes.

The first case would be identified if a group of people continually prearrange trades among themselves and there is a pattern of trading activity among people. The computer system could pick that up.

Now, this is what the exchanges have told us, that their software is capable of doing. We have not gone in and tested their software to determine whether or not it can do what they say it can do, but they do flag a lot of cases for further study as a result of their computer systems.

Mr. Fogel. Do you have anything you want to say?

Mr. Burnett. I would just like to add to that that I think the bottom line on what abuses can occur depends a lot on the sophistication of who is doing the abuse; and, if they understand how these systems work well enough, they can probably do what you say. If they do not and their trades are flagged by the system, they can be caught as well.

Senator Daschle. Let me move on in what limited time that we have.

To move off detection and on to enforcement, if I understand what you have already told the committee is that, from your initial investigatory work, you are fairly satisfied that the CFTC is diligently enforcing the regulatory processes as you understand it at this point, so I will not ask any questions with regard to that at this point although I have some that may be pertinent later on.

What I would like to do, though, is ask about disciplinary action. I see what appears to be an imbalance in the leveling of fines in the Chicago Board of Trade, and the disciplinary action taken.

Is it also your view that with regard to disciplinary action that we have been as forceful or as rigorous as we might be?

The impression that I have is that, while you certainly cannot come to any conclusions, it certainly begs some questions about enforcement, and would lead anyone to ask where is the CFTC with regard to the allocation of fines, and whether or not, here again, CFTC is as successful in this part of their responsibilities as is the SEC?

Could you elaborate a little bit more on that?

Mr. Fogel. I think that is a fair impression that you have. You know, when I say we are satisfied with the CFTC, that does not mean that we think they are doing the best job possible. I think on the enforcement side and the disciplinary side, it certainly does raise those types of questions.

For example, if you just look at the major exchanges, the Chicago Merc and the Board of Trade, they had different ranges of violations, the fines were not necessarily consistent, and you can raise questions: What was the CFTC doing in looking at that?

You know, were they pressing the exchanges more on that?

We have read some cases where one of the exchanges sent a letter to a person six or seven times, saying, you were not filling out your cards properly. It gets into this 15-odd percent where the bracket times may not be recorded correctly, and you need to do that.

The question is, how many times do you send them a letter before you fine them? Or if you just fine them a little amount, they will say, so what, and they go tell their friends, "Geez, I got a little slap on the wrist, and you can do it too and you are not going to get fined too much."

So, that is why we wanted to compile the data. I think the data certainly raises a number of questions that need to be pursued as to the level of fines, the intensity of the effort, on both the CFTC and the exchanges.

Ms. **Trop**. In this last rule enforcement review, though, the CFTC did recommend that the Board of Trade start fining traders who were not properly recording data for the audit trail system because it said that if the data is not accurate, it is hard to detect abusers, and those people could likely be the very abusers that are not being detected—the ones who are not properly recording.

Senator **Daschle**. I am not clear from what the chart shows as to what the CFTC disciplinary actions have been. Do they incorporate whatever CFTC required of the Merc and the Board of Trade with regard to discipline?

Mr. **Fogel**. No. No. Those are just the disciplinary actions that the exchanges took.

Let me go back and highlight it for you: From 1986 to 1988, the CFTC initiated enforcement actions resulting in over $900,000 in civil penalties: 35 cease and desist orders, 43 trading suspensions or revocations, and 31 registration suspensions or revocations.

So, those would have been things that it would have done above and beyond what the exchanges did.

Again, I think your question is a very valid one, which unfortunately we do not have the answer to today, is relative to the effort that they put in—let's say, what were the results from the CFTC and how does that compare, for example, to enforcement actions that the SEC may take.

Senator **Daschle**. I also do not have any understanding, and I certainly would not expect you to provide that understanding today, but any understanding as to whether this represents merely a slap on the wrist or capital punishment with regard to participants?

We really have to have a better sense of the relative weight of the disciplinary action taken before we can really apprise whether or not discipline in this case has been enforced or not.

Mr. **Fogel**. Now, that is a very good point, and in the work we have done, I asked the questions, for example, of the staff in preparing for this: Is there a range of fines based on the severity of the action? How do the exchanges sort of classify the types of violations?

The exchanges do have some classification, and the way the staff explained it to me—let's put it this way: I wasn't overly impressed with what I heard in terms of how they decide things. Obviously, you have to have some flexibility, and it really depends on what the member has done, whether he or she has done something over a period of time and the consequences, did a customer get hurt? Or was it another type of violation?

But I think those are lines of inquiry that ought to be pursued, and we reached the same conclusion. We just do not know. Obviously, expulsion is a fairly significant action. You are depriving someone of his or her livelihood on that exchange.

There are not too many, and I guess if I were sitting on an exchange, I would be pretty cautious about doing that too before I deprived someone of their livelihood.

I do not know whether eight or two, or one is adequate.

Senator **Daschle**. Thank you, Mr. Chairman.

The **Chairman**. Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

A number of weeks ago a major player on the exchanges was in to visit with me, and I asked him: Did you know that these abuses were occurring at the time that you were involved in the market?

He said yes. He said, "It's well known." He said, in his experience, 95 percent of the traders are very honest, very ethical, take very seriously their responsibility to their customers. He also said, 5 percent are just very sleazy. And he said that it is very strange because there does not seem to be much in between. They are either honest or sleazy.

And I asked him, "How about the CFTC? Are they doing a good job?

He said, "Well, I think you have to understand regulators. They are doing a good job in the context of being a regulator, but, very honestly, the regulators do not know and cannot know what is going on." He continued, "It is just the reality. There is such intensity on that floor, and anybody who has been there knows that is true; that if you have some bad apples, they are going to be able to cheat, and if you have an audit trail with a 30-minute window or a 1-minute window, they are going to find a way to cheat." He added, "Look, you need to understand that in government, the fact is, you have to find the way to create a system in which the traders regulate themselves, that there is an incentive for the trade to take care of their own dirty linen."

He said, "I'll tell you, I'll just give you an example. In any 10 regulations that have been promulgated, 5 are basically irrelevant in protecting the public, 3 help, and 2 hurt. This is not just my opinion; you go to the trade and talk to the people who are trading and they will say, in no way, is a regulator going to be sufficiently aware to be on top of all activity to prevent abuse."

And so, he said, you have to find a way to get the trade to police its own.

I would be interested in your reaction to that set of observations. Again, this is somebody who had been in the trade, had been in the trade a long time, was a major player, and I would say it is fair to say has a significant reputation.

Mr. **Fogel**. Well, that is one of the reasons I think that we in GAO are satisfied that you have to have a good relationship between the Federal regulator and why you have self-regulatory organizations. I think everyone recognizes you would not want the

Federal regulator to try to do everything; the Federal regulator could not. That is why it is so important initially in an inquiry to look at the adequacy and the commitment of the exchanges themselves to regulate.

It goes back to what Senator Lugar said. They have more of an incentive than anyone to try to get those bad apples out of there because it is going to affect their livelihood, and the question has to be asked: what is the attitude of the people on the exchanges to regulate their own?

I think that is why this baseline data becomes important. It really gets down, unfortunately, to people's commitment and willingness to play straight. I agree you can have an awful lot of rules and regulations, but it gets down to, are they really serious about doing it themselves?

I have talked to friends in Chicago, too, who say, yes, basically the same thing—you know, most stuff is done very honestly and very fairly but they always thought there was some shaving, something going on, and now these guys are a little more cynical, and just sort of accepted that as part of the life out there.

But they didn't say that was correct. But again I think the first place you have to look is the commitment of the regulators, I mean of the SRO's.

Senator CONRAD. What incentive could we provide for the exchanges themselves to more effectively police their own?

Do you have any idea? The point he kept making to me was, Senator, if you really want to do something about this, you can do all you want about the CFTC or the SEC, or any other regulatory body; you have to find a way to create incentives——

Mr. FOGEL. Well, I think——

Senator CONRAD [continuing]. With the trade to police itself.

Mr. FOGEL. I think one very good incentive is public disclosure of what is happening or not happening. The fact that some of these statistics are out, you are going to be asking more questions, more followup. You know, that is one positive thing, for example, in rule enforcement reviews at the CFTC. I do not know if many people knew, but their reports are public. That is a fairly positive incentive, it seems to me, as opposed to some of the other regulators whose reports are not public. It is difficult then to find out what is going on. Public reporting has a salutary effect because it forces them to respond.

I think another thing you can do when the CFTC requires these exchanges to take action, as a result of their recommendations, is to follow up fairly aggressively with the exchange and say, what are you doing? Are you aggressively implementing the recommendations? If not, why not? What is the problem? And then do these make any difference?

We have not, quite frankly, Senator, thought through enough in terms of other types of incentives, in terms of additional regulations or fines or that type of thing.

Senator CONRAD. If I might, just one last question, Mr. Chairman.

One, I would just like to make the observation: I think it would be worth while that we spend some time on additional incentives. I sense that he is probably exactly right. He had been there a long time, street-wise person, that we need to find some ways to provide incentives for the exchanges to police themselves.

I have one final question: In your review, did you find that the CFTC sanctioned traders on the Board of Trade more or the Chicago Mercantile Exchange more? Or was there a difference?

Mr. FOGEL. We would have to get you that information. I do not know at this point in time.[2]

Senator CONRAD. I would be very interested in the relationship, given the relationship you see here of the exchange itself, whether or not a similar pattern emerged——

Mr. FOGEL. By the CFTC.

Senator CONRAD [continuing]. By the CFTC, or if it was different in some way?

That might give us some idea how the exchanges themselves are doing.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman.

It is nice going last.

I want to sort of reference back to my opening statement and let you know that I do have some reservations in general about the capacity to regulate. I have found myself in the process of listening, getting a kind of visual image of the movie, "Tin Man," and remembering when I saw the movie "Tin Man," my sympathies flowed to Devitto and Dreyfuss, not to the guy sitting behind the table and leading the inquiry.

Mr. FOGEL. Right.

Senator KERREY. And now I am behind the table wondering how much urgency I should feel, how big a problem we have here, and what our response should be. How much action should we take? How thunderous should our outrage be?

I must tell you I was sort of attracted to the terms that you applied to potential abuse, and I am curious, the "bucket," "wash," "curb," "cuff," "cross"?

Mr. FOGEL. Those are the market's terms, not ours.

Senator KERREY. Interesting.

Mr. FOGEL. GAO is not that creative usually. [Laughter.]

Senator KERREY. Does that imply that the abuse is so pervasive that the traders on the floor have a name for it?

Mr. FOGEL. I do not think it implies that they are that pervasive.

Senator KERREY. But they have come up with these terms.

Mr. FOGEL. That is right.

Senator KERREY. This is not a nomenclature developed by you or developed by the FBI.

Mr. FOGEL. That is right.

Senator KERREY. They actually have an established name for each abuse.

They have categorized it.

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[2] See material submitted for the record, September 8, 1989. Responses were provided in appendixes I–XII, as well as overall conclusions and recommendations. The September 8, 1989 hearing will be printed as Oversight Hearing With Respect to the Reauthorization of the Commodity Futures Trading Commission—Trading Practices in the Commodity Futures Markets—Part II.

Ms. Trop. The origin——

Senator Kerrey. Which makes your work easier, I assume. [Laughter.]

Ms. Trop. The exchanges have been organized in some respect to keep these kinds of abuses from happening, and the CFTC has been created in some respect in keeping these things from happening.

For example, it used to be "bucket shops" before—and there still are, I guess—that are illegal. But before there was an organized exchange, they were all over the place, so a lot of these names, designations predate floor trading, even.

Senator Kerrey. But it does indicate that at some point in time they obviously had to be pervasive enough that the jargon developed.

Mr. Fogel. Yes.

Senator Kerrey. What sort of indication do you have that either the Merc or the Board or the CFTC has brought into play what I would call just ordinary training sessions as the rules change?

I am aware that traders come and go on the floor. A trader that trades all week this week may not be there again for several months. Do they attempt to communicate an urgency to self-police through training mechanisms?

Ms. Trop. The CFTC in both of its rule enforcement reviews at the Mercantile Exchange and the Board of Trade did evaluate the educational programs, some of them at each exchange, and were positive.

Senator Kerrey. I must also tell you that on the surface I am not very impressed. I mean, it seems like a pitiful response. Fifteen sanctions for the Board of Trade out of 140 million contracts traded. And 105 for the Merc out of 80 million contracts traded.

What would be interesting would be to do a relative analysis of the estimated fees that traders received on the floor compared to the fines levied overall.

I mean, I am not tremendous with bar graphs and presentations like this, but I look on the surface, and it looks like a pitiful response, particularly given, by the way, the capacity of other marketplaces to regulate without interfering seemingly with the need to provide liquidity to the people that are out there selling the product.

For example, I think an analysis of the success of merchants to regulate shoplifters would probably conclude that the lesson learned by the shoplifter as he looked at the Board of Trade and Mercantile Exchanges is that he really ought to just set his sights a bit higher. [Laughter.]

Mr. Fogel. That could be.

Senator Kerrey. I mean, have you done any relative analysis between what sort of sanctions have been applied and the amounts of fines that other markets have done so that we can get some sort of comparison? I am really genuinely trying to determine whether or not I ought to put a lot of energy into trying to figure out what we ought to do in response to this problem, trying to determine how serious a problem we have.

Mr. Fogel. I think the answer is no, we have not yet, but that is one of the things that as we got into this, it was very clear that we needed to know, and everyone needs to have a perspective on, and we are willing to do that for you, so you can make a judgment as to how serious the problem here is, vis-a-vis the other exchanges.[3]

But, you know, statistics help, but it also gets back to something I think Senator Leahy and Senator Lugar were saying very early on. That is the impression that people have as to whether the markets are fair, and a lot of times that is based on intuitive judgments not just the statistics, but the statistics are very important in this case to get a better perspective.

Senator KERREY. In your remarks you indicated that when it came to the sanction of expulsion, it is actually a fairly serious sanction because someone's livelihood is at stake. Is that an attitude, do you think, that is relatively pervasive? I hear it, by the way, as a pretty common plea by white-collar criminals who say: "Gee, my livelihood is at stake here, so go easy on me."

And I find it to be a defense, by the way, that generates almost no sympathy at all, from me.

Mr. FOGEL. No, I did not mean to imply that. What I meant to imply is that—and this is based on my impression but not hard data—that when you are going to make a decision of that magnitude to expel them or do something that serious, you are going to be more deliberate than you are if you are just going to fine someone $10,000 or $20,000.

What I was trying to imply was I do not know whether, like I said, one, or three, or eight, or two is enough, but it is reasonable to assume that you are going to make those decisions with a lot more deliberate care than others.

Senator KERREY. But based on 220 million contracts traded, in 1988, on the Merc and the Board, it would seem to me that if I were a trader, and I am trading in 1989, given the experience of 1988, I would say, you know, the risk of doing a bucket or a wash or a curb or a cuff or a cross does not seem to be that great.

Mr. FOGEL. You may——

Senator KERREY. Do you draw that conclusion as you look at the numbers?

Or am I asking you to draw a conclusion that is unfair?

Mr. FOGEL. Well, I think if you look at the numbers, you would have to say that that is right, the risk of being sanctioned is not too great, based on those numbers and the relative——

Ms. TROP. But we do not know how many abuses are actually occurring, so that if there are very few abuses occurring if that were to be the case, then these numbers might not be bad.

The suspensions numbers also are a little bit misleading. You can be suspended for a very long period of time and not expelled, but in a sense you would be kicked off the exchange.

Senator KERREY. But the dilemma that we are in is that in order to discover how much abuse is there, we are going to have to ratchet the market itself down. I mean, we are hearing from you that self-regulation is——

Mr. FOGEL. Is part of the process.

Senator KERREY [continuing]. One of the essential ingredients here; and, so, it seems to me, that one of the things that must happen if self-regulation is going to be effective is that those sanction numbers are going to have to change.

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[3] See footnote 2, page 43.

I am permitting you to argue with me.

Mr. FOGEL. Right.

Senator KERREY. That just looks like a relatively low number, and my suspicions are the FBI is going to identify through their Sting operation a relatively pervasive pattern of bucket, wash, curb, cuff, and crossing.

Mr. FOGEL. Yes.

Senator KERREY. Again, nomenclature that you did not come up with, the FBI did not come up with, but is an established nomenclature that everybody knows about on the floor.

Mr. FOGEL. I guess that the reason I do not want to engage you in this right now is that we are just uncomfortable because we do not know either. We just got the statistic together, and I think the dilemma we all face is we are going to have to wait and see.

You know, it may very well be that the scope of the abuse is not as important in terms of numbers as what happened, and let us say that the FBI and the U.S. Attorney out there doing the work on this find some serious problems, and certainly you could say that if, you know, it was not widespread, that is one positive thing.

But if there were serious abuses, even if it were just a few, that tells you that it could occur, and then you still would have to question how the exchanges are monitoring things and how the CFTC monitors it.

Senator KERREY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kerrey.

I would follow up a little bit on one point that you were raising, an area where we are exploring ground and are not sure yet what the numbers are. I was struck by the numbers of sanctions, the numbers of suspensions and so forth shown on the charts.

Of course, we will not know until we see more on the Justice Department's investigation and what they view as the level of abuses.

We keep going back to the question, though: What is the intensity of the Chicago exchange enforcement programs? I think that is a very legitimate question in this kind of oversight.

I wonder if you are going to compare the enforcement programs at the Chicago futures markets with those at other futures exchanges or securities exchanges such as the New York Stock Exchange?

Mr. FOGEL. I think we would really be willing to sit down with you and the staff and work out comparisons that you think would be relevant. I think you have to compare it to other futures exchanges first, and I think you have to recognize we could make—we should make some comparison between the futures markets and the equities markets but you are dealing with different situations there.

But I think those are useful. Then, if they can be developed and explained, it hopefully would provide you a better perspective.

The CHAIRMAN. There is an implication here. Someone suggested earlier that it is terrible that these things are happening on the futures markets, unlike the markets that the SEC oversees. Well, of course, we all know that there have been abuses in securities which have been vigorously prosecuted. I would like to work out with you some way to compare the ability of the CFTC to scrutinize and oversee the types of markets that it regulates, as compared with the SEC's capabilities for the markets that it oversees. I would like to see whether their oversight abilities are comparable, or whether the settings are so entirely different that you cannot compare.

One thing that I am interested in is in these types of abuses we have read about and heard about, who has been hurt more? Is it the large institutional traders like pension funds and commodity pools? The small retail public investors? Small commercial users like farm producers and grain elevators? Who gets hurt the most?

Mr. Fogel. Go ahead.

Ms. Trop. The discussion from what we have heard is that the smaller, middle-sized investor is more likely to be hurt. The institutions have lots of traders on the floor, their own sometimes, and also they are using a lot of independents. They know what the prices are. They can see discrepancies easily in prices.

The smaller investor is more likely to have to rely on the exchange to assure that the prices they are getting are fair because they do not have the time or the resources to monitor the market closely.

The Chairman. I understand from the testimony your concern that the open outcry system is vulnerable to abuse because of, first, high price volatility; second, large trader participation; and, third, reliance on individual reporting.

Is this really much different from securities markets? I am thinking, for example, of a heavily traded stock on the New York Stock Exchange, which can be very volatile if you just look at the Wall Street Journal each morning. It can be subject to upstairs trading off the exchange floor and it can involve large numbers of people around the trading booth or through computer networks.

I have far less expertise in the securities markets than I might have in this area. Can not the same kinds of abuses occur in a securities market as in the futures markets?

Mr. Burnett. There are abuses that can occur in the securities markets. Whether they are the same kind or not probably really does not matter. The point is that abuses can occur, and the key question is how are you set up to deal with those abuses? How does your structure fit the problem?

Mr. Fogel. There is certainly the possibility in the securities markets for a specialist or a trader to trade for his own account ahead of a customer order. There are very strict rules on the books that have to be kept on the computer screens as to how you do that. The exchanges try to monitor that.

The one difference is that you do not have the open outcry system, so there is a little more control in terms of seeing what the prices are that are coming in and going out because of the way the orders are executed on the floor.

Mr. Burnett. Well, there is a different set of words on the exchange.

The Chairman. I understand.

Mr. Burnett. The stock exchange.

I mean, instead of "accommodation trading" and "cuffing" and "bucketing," you have "stock parking" and "insider trading" and "pegging" and "marking the close."

But the point is that there are violations in both markets that need to be monitored.

The CHAIRMAN. I understand that "bucketing" was an expression that came into being somewhere around the 1880's.

The Chicago Merc and Reuters have talked about setting up "Globex," an electronic trading system. Would such a system safeguard the markets from trading abuses or would it just raise the potential for new problems?

Mr. FOGEL. Well, I think it is like we said earlier. Certain abuses would be more difficult to effect on that type of system, but there could be other abuses that could occur, and, as Mike was just saying, over time, I am sure that there will be terms that will develop there too.

That is why it is so important as we go into some of this computerized trading that the regulators be up to speed. But there could be abuses of a different sort.

The CHAIRMAN. I see.

I must say that you have been extremely helpful to us. You have done a lot of work so far, and both Senator Lugar and I and other members of the committee will call on you further as we go through this. Futures trading is an extremely complicated area, one that with our own staff we are unable to look into all its complexities. Certainly the situation will be evolving as we hear more from the Justice Department.

The Chicago investigation is a matter of great concern not only to me but, I think, to all members of this committee. What I would like to do is to go back to some of the notes from today's hearing and then get together with you very soon to lay out some parameters and questions that we will need more information on. We will figure out where to go from here.

You might want to pass on the word down at GAO that we are probably going to keep you busy on this subject for some time to come. GAO will be an extremely important part of this inquiry.

Mr. FOGEL. Right.

Well, we look forward to working with you on this, Mr. Chairman.

The CHAIRMAN. Well, I will keep the record open for any questions any of us might have.

Dick, did you have anything further?

Senator LUGAR. Mr. Chairman, I would just like to underscore the thought among these parameters the chairman is talking about, please be thinking about potential abuses of the electronic system.

Mr. FOGEL. Right.

Well, we will get some of our computer people working on that very quickly.

Senator LUGAR. So that we begin to weigh these two things together, as regulatory mechanisms.

Mr. FOGEL. Right.

The CHAIRMAN. Thank you very much.

We stand in recess.

[Whereupon, at 12:05 p.m., the committee recessed, to reconvene at 9:05 a.m., Thursday, March 9, 1989, in room 332, Russell Senate Office Building.]

[Material submitted for inclusion in the record follows:]

APPENDIX

March 1, 1989.

The Honorable RICHARD FOGEL,
Assistant Comptroller General, General Government Division, U.S. General Accounting Office, Washington, D.C.

DEAR MR. FOGEL: Thank you very much for testifying at our hearing on trading practices in the commodities futures markets on February 23, 1989.

Enclosed are questions submitted for the record by Senator Robert Kerrey. We would appreciate responses to these questions by March 17. Please return your responses to Betsy Paul, Hearing Clerk, 328A Russell Senate Office Building.

Sincerely,

PATRICK LEAHY,
Chairman.

Enclosure.

QUESTIONS SUBMITTED BY SENATOR ROBERT KERREY TO GAO

HEARING REGARDING THE COMMODITY EXCHANGES

FEBRUARY 23, 1989

1. Dollar Value of Sanctions vs. Dollars Cleared

Would GAO develop an analysis of the total dollars changing hands and the estimated income of floor traders/brokers during 1988 at the Chicago Board of Trade and the Chicago Mercantile Exchange? The analysis should be designed to provide a perspective on the relative significance of the sanctions and fines invoked in exchange disciplinary actions as compared to broker income.

2. Findings at Other Futures Exchanges

Is there evidence that abuses of a similar nature to those reportedly involved in the Chicago probe are occurring on all the exchanges? How do the findings of the Rule Enforcement Reviews of the New York futures exchanges compare with those of the Chicago exchanges. How do the disciplinary actions of the New York exchanges compare with the disciplinary actions reported for the Chicago exchanges?

3. FBI Investigations at Exchanges Outside Chicago Area

Has the FBI conducted investigations at the New York futures exchanges or any other exchanges besides the Chicago exchanges? If so, would you provide a summary of the results of the investigations? If no FBI investigations have been conducted at the other exchanges, is there any reason for the lack of investigation at the other exchanges?

4. GAO Sanction Authority

What types of sanction authorities are available for CFTC to impose on the exchanges? Can CFTC sanction individual brokers/traders? What additional sanction authority would GAO recommend be provided to CFTC?

[See material supplied by GAO for the September 8, 1989, Part II, hearing for responses to these questions.]

OVERSIGHT HEARINGS WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Trading Practices in the Commodity Futures Markets

THURSDAY, MARCH 9, 1989

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:05 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Heflin, Harkin, Conrad, Daschle, Baucus, Kerrey, Lugar, Cochran, McConnell, Bond, and Gorton.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. Good morning. Today we are going to continue our oversight hearings on trading practices in the commodity futures markets.

Two weeks ago, the General Accounting Office put before this committee the pivotal question, still to be answered, raised by the reported Chicago criminal probe: have the futures regulators—the Commodity Futures Trading Commission and the exchanges—acted with sufficient "intensity" in working to detect and punish trading abuses?

The Commodity Futures Trading Commission wears two regulatory hats with respect to trading abuses, first, of course, to oversee the self-regulators, and second, to patrol the market directly.

In its overseer role, the CFTC is responsible for assuring that the exchanges perform their self-policing functions properly. The Commission must approve all major exchange rules and give each exchange a periodic rule enforcement report card. When an exchange gets bad grades, the CFTC is to see that the exchange in question makes improvements.

In its policing role, the CFTC patrols the markets, maintaining its own computerized system to monitor trade practices. It has the authority to bring disciplinary cases against rule violators.

So, in these hearings, it really boils down to this: I want to examine the CFTC's performance in both these roles. What kind of judge has the CFTC been for the exchanges? Is it a hanging judge, or does it hand out revolving door justice? Or something in between? Has it been tough enough in getting the exchanges to adopt reforms where needed? Of course, the bottom line is, just how aggressively has it used its direct disciplinary powers?

The small size of the Commission, I feel, belies the extreme importance of its job. In fact, I have to wonder how it manages on the limited resources available to it.

Futures trading has grown dramatically in recent years. The number of contracts traded on U.S. exchanges grew by more than 200 percent from 1979 to 1988, jumping from 74 million to 263 million per year, over a quarter of a billion contracts per year.

During this same period, the CFTC's staff grew by only 12.6 percent, from 460 to 518.

To demonstrate this point, the committee has prepared several charts based on the CFTC's own data showing staff size next to industry trading volume, and I will get to those in a moment.

These numbers, though, raise an obvious question: Have we been penny-wise and pound-foolish with the CFTC? Has this agency's small size limited its ability to keep up with the industry it oversees?

If our review demonstrates that the CFTC needs more staff or more legal powers to meet its responsibility to keep the exchange floors clean, then we have to be prepared to respond.

Certainly, a key factor in our judgment will be what role the CFTC played in the initiation and the conduct of the current Chicago criminal probe. The CFTC may be constrained on this point today, as are we, in respect for an ongoing investigation. But it should be understood that before any CFTC reauthorization bill moves forward, we are going to need more information than we now possess.

Chairman Gramm, I know that you and your staff have done a great deal of work in preparing for today's hearing, and we appreciate it. You have met with Senator Lugar and myself earlier, and we asked a number of questions there, and I should note that I certainly appreciate the cooperation and the hard work that we have had from you. We look forward to your testimony.

Now if I could point out the various charts: chart 1 shows two graphs from the CFTC's 1990 budget estimate submitted to Congress in August 1988. The top graph shows trading volumes on U.S. futures exchanges for fiscal years 1979 through 1988. The bottom graph shows CFTC staff levels during this period.

Now, there is a second chart. It is a graph created by the committee staff. It shows the number of futures contract trades for each CFTC staff member during the 1979–88 period. It is based on the CFTC's 1990 budget data.

Chart 3 shows the size and budget of the CFTC's Enforcement Division over the past decade. And it was taken from CFTC's prehearing submission.

Chart 4 shows the staff size of the Contract Market section within the CFTC's Division of Trading and Markets as the principal regulatory overseers of the exchange floors.

Chart 5 shows the size and budgets of the compliance staffs at the exchanges themselves. I just mention what all those are because we will be referring to them as we go along.

By comparison, I received a letter from the New York Stock Exchange through GAO showing the stock exchange's regulatory budget in 1988 at some $68 million with a regulatory staff of 544. I have not included the stock exchange numbers in chart 5 because the exchange programs, I understand, are not directly comparable. But I would ask unanimous consent that the New York Stock Exchange letter be placed in the record at this point, and without objection it will be.

[The New York Stock Exchange letter with an attachment, exhibit B, and the charts referred to by Chairman Leahy follow:]

11 Wall Street
New York, NY 10005
212 656 2240

Gerald F. Clark
Senior Vice President
Government Relations

NYSE
New York
Stock Exchange, Inc.

[illegible]

March 7, 1989

Mr. Thomas C. Bittman
Audit Manager
United States General
Accounting Office
26 Federal Plaza
New York, New York 10278

Dear Mr. Bittman:

This will respond to your request for information relating to New York Stock Exchange staffing and expenses committed to regulation. These data cover a span of four years (1986-9) and provide focus on regulatory expenses associated primarily with the three line divisions (Member Firm Regulation/Enforcement/ Market Surveillance) which include direct expenses, general and administrative expenses, allocated expenses and manpower allocations.

As you review this information, it is important to consider the Exchange's specific role in the overall regulatory scheme which has evolved in the U.S. capital markets. Today, Exchange self-regulation is conducted within the framework of Federal statutes governing the transaction of business in securities, commodities and financial futures. The Securities and Exchange Commission has designated the New York Stock Exchange as the primary self-regulator for almost all its members, even though most of them belong to several exchanges and other securities industry organizations. In the regulation of such member firms this Exchange is responsible to and works closely with the SEC.

In our view, the first level of the regulatory framework in the United States begins with the individual broker-dealer. Recognizing the firms' direct relationship with the full spectrum of customers, it is their fundamental, individual responsibility to comply with all Federal securities laws and Exchange rules and procedures as codified, for example, in the Securities Act of 1933 and the Securities Exchange Act of 1934, related amendments, and the NYSE Constitution and Rules. The impact on firms is comprehensive; covering the fair and equitable treatment of their customers, financial and operational requirements, sales practice requirements, safekeeping of customers' assets and regular reporting to the self-regulatory organizations. In addition, each firm is responsible for appropriate supervisory, compliance and audit procedures. Important recent additions to our rules, called Regulatory Initiatives (Exhibit A), heightened attention to these responsibilities by further raising the priority of compliance and supervision matters within each firm to the Chief Executive Officer and Executive Committee level.

The self-regulatory organizations (NYSE, NASD and other national securities exchanges) provide the second level of regulatory oversight. At the NYSE, the divisional configuration of the Regulatory Group reflects our responsibilities:

NYSE Line Divisions	Primary Functions
Member Firm Regulation	o Examination of member firms' financial/operational compliance o Examination of member firms' sales practices and procedures o Customer complaints o Rules development o Agent registration/administration
Market Surveillance	o Surveil NYSE Trading Floor activity (Specialists/block firms/RCMM's/CT's) -- proprietary and agency activity o Stock Watch o Surveil and investigate equity and options markets o Upstairs proprietary trading (including program trading)
Enforcement	o Investigation/case development o Prosecution of rules violations

In addition to our line divisions, the Exchange also utilizes a separate Regulatory Quality Review unit which serves as an internal audit arm, assessing the effectiveness of our regulatory efforts. Also, our Regulatory Technology unit provides group-wide systems development capabilities, enhancing existing automated regulatory systems, as well as developing the technological tools necessary to address emerging regulatory responsibilities.

The third level of regulation resides with the Securities and Exchange Commission, the Federal Reserve Board, the Commodities Futures Trading Commission and state securities commissions, which provide governmental oversight of the marketplace. Finally, the Congress provides specific statutory direction by virtue of its legislative and oversight activities.

The total resources which are brought to bear on securities industry regulation in this country are significantly greater than that attributed to any single level of the overall regulatory scheme. The attached matrix (Exhibit B) sets forth details pertaining to the NYSE's regulatory budget.

I trust that the foregoing information satisfies your request.

Sincerely,

Attachments

(Exhibit A is retained in the Committee file.)

(Exhibit B follows:)

Exhibit B

NYSE REGULATORY EXPENSES

	1986(a)	1987	1988	1989(c)
TOTAL EXPENSES ($000's)	$ 44,067	$ 52,866	$ 68,630	$ 76,055
Divisional Expenses				
Enforcement	6,025	8,045	11,529	13,088
MF Regulation	22,127	23,444	26,088	29,454
Mkt. Surveillance	11,228	16,111	15,944	17,383
Group & Reg Admin.	4,108	4,724	5,706	6,327
Reg. Technology (b)	n/a	n/a	8,549	8,887
Reg. Quality Review	579	542	814	916
TOTAL STAFFING	373	454	544	549
Divisional Staffing				
Enforcement	42	79	104	109
MF Regulation	191	220	243	243
Mkt. Surveillance	85	97	110	110
Group & Reg Admin.	49	52	59	59
Reg. Technology (b)	n/a	n/a	18	18
Reg. Quality Review	6	6	10	10

(a) 1986 Division totals are pro forma, compared to subsequent years, reflecting divisional reorganizations

(b) Automation development functions were placed in a separate division (Reg. Technology) beginning in 1988

(c) 1989 Budget

3/6/89

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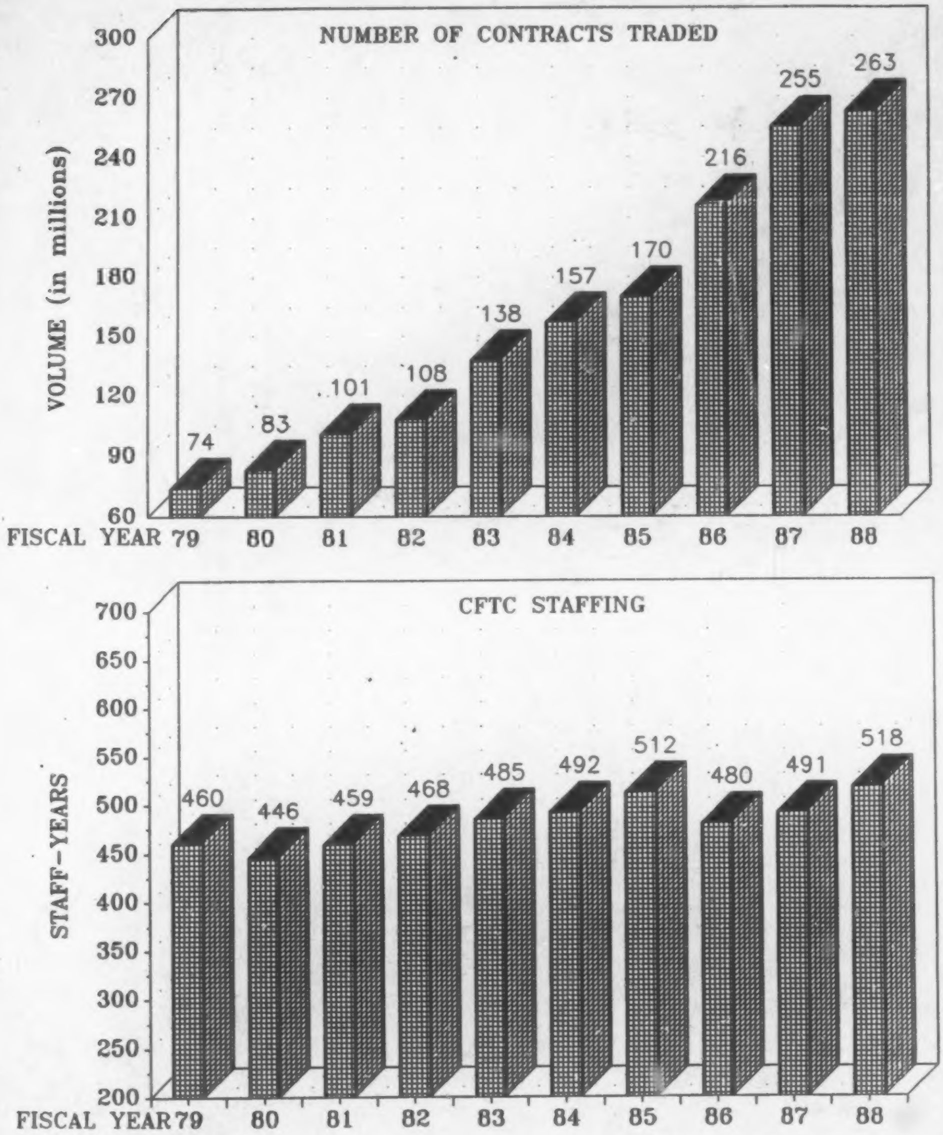
CHART 1

Trading Volume vs. CFTC Staffing



SOURCE: Commodity Futures Trading Commission, Budget Estimate, August 1988

CHART 2

CONTRACTS PER CFTC STAFF YEAR

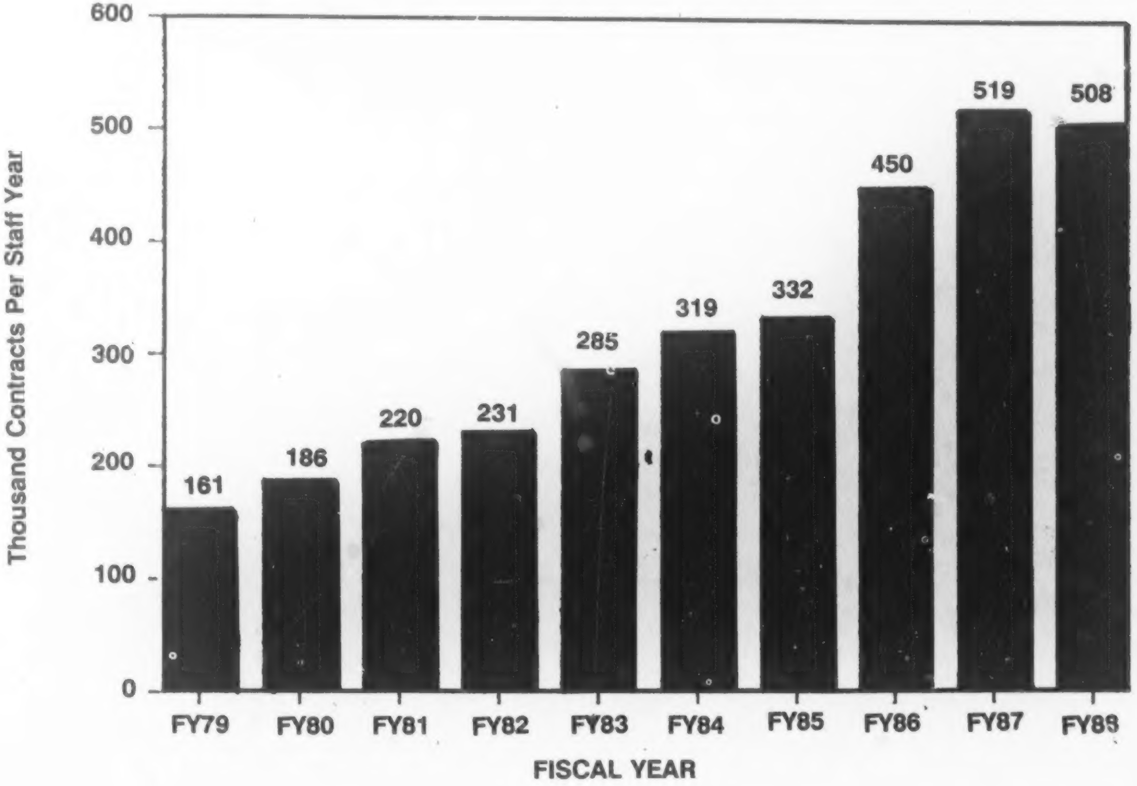


CHART 3

CFTC Enforcement Division

FY	Dollars (in thousands)	Staff level
1980	4,295	106
1981	4,406	106
1982	5,104	110
1983	5,252	114
1984	5,545	109
1985	6,717	125
1986	6,621	118
1987	7,362	125
1988	8,203	136
1989	9,118	144

SOURCE: Commodity Futures Trading Commission

CHART 4

CFTC Trading & Markets Division
Contract Markets Section: Budgets & Staff

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Funded FTE	18.8	31.8	30.9	31	34	34	33	37 8/	32
Amount (000)	$ 706	$1,269	$1,357	$1,408	$1,640	$1,650	$1,734	$2,060	$1,878
Dedicated 9/ FTE	N/A	N/A	N/A	N/A	N/A	27	26	30	30
Regional	N/A	N/A	N/A	N/A	N/A	10	12	12	14

8/ These figures are for total funded full-time staff years, not the actual number of staff positions, and include staff years for the Contract Markets Section, as well as staff years allocated to the Director's office and legal counsel from 1980 - 1987. For the period 1980 - 1987, commensurate with the increase in FTEs, approximately three staff years to seven staff years were attributable to the Director's office and legal support. For FY 1988, the reduction of five FTEs is due to the allocation of those FTEs to the formal establishment of a subprogram with respect to regulatory development activities which represents those positions formerly allocated to legal support. Also for 1988, two FTEs were allocated to the Director's office.

9/ These figures are staff years dedicated to oversight and surveillance activities.

SOURCE: Commodity Futures Trading Commission

CHART 5

Exchange Compliance Staffs

Figures generally include staff who have direct duties in the Compliance Department, e.g., trade practice, audit trail, financial audits, market surveillance, and legal and computer staff.

Chicago Board of Trade	1980	1982	1984	1986	1988
Compliance Budget	$1,016,000	1,337,000	2,004,000	2,657,000	3,553,000
Compliance Staff	44	48	70	78	83

Chicago Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Budget	$2,036,000	3,008,000	3,785,000	5,925,000	7,830,000
Compliance Staff	32	37	40	60	89

Coffee, Sugar and Cocoa Exchange	1980	1982	1984	1986	1988
Compliance Budget	$411,535	661,385	616,500	676,000	852,000
Compliance Staff	19	19	17	17	23

Commodity Exchange, Inc.	1980	1982	1984	1986	1988
Compliance Budget	$622,000	890,000	1,155,000	1,527,135	1,015,000
Compliance Staff	24	34	39	29	33

Kansas City Board of Trade	1980	1982	1984	1986	1988
Compliance Budget	$90,000	145,000	175,000	368,000	252,600
Compliance Staff	4	6	7	7	5

Minneapolis Grain Exchange	1980	1982	1984	1986	1988
Compliance Budget	$76,800	105,000	118,230	167,350	312,000
Compliance Staff	2	2	2.5	3	8

New York Cotton Exchange	1980	1982	1984	1986	1988
Compliance Budget	$444,087	550,155	504,394	869,000	1,400,000
Compliance Staff	10	11	10	17	15

New York Futures Exchange	1980	1982	1984	1986	1988
Compliance Budget	$3,395,000	2,156,000	400,000	1,100,000	1,050,000
Compliance Staff	22	16	6	7	11

New York Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Budget	N/A	710,690	812,500	819,359	2,345,000
Compliance Staff	11	15	20	18	33

SOURCE: Commodity Futures Trading Commission

The CHAIRMAN. Dick, I yield to you.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. Thank you, very much, Mr. Chairman. I would like to begin by extending a warm welcome to Mrs. Gramm and thanks, as the chairman has pointed out, for the previous consultation on the ongoing problems before us as well as the specific crisis.

Just 2 weeks ago on February 23 we convened a hearing in this room to begin the process of examining the futures industry trading practices. At that hearing GAO officials provided the committee members with a review of various types of trading abuses that may occur under the systems that are in place to monitor and control those activities. The GAO testimony also reviewed the disciplinary record of the CME and the CBOT.

However, the thrust of the statement was to suggest a focus of inquiry for the committee as it proceeds to investigate the matters at hand. And the suggestion was to review the level of intensity of the efforts of the CFTC and the exchanges to detect and to sanction trading abuses.

While I believe there are many areas for exploration and analysis by this committee as we proceed to look at the operation of the futures industry and the effectiveness of the regulatory system that we now have in place, I welcome the suggestion by GAO and I hope that Chairman Gramm will comment on this issue today; specifically this idea of the intensity of the effort.

In addition, I welcome comment by Chairman Gramm on the audit trail system generally. Is it working? Is the system used on any of the exchanges superior to that used on other exchanges? Also, on the reliability of the source information that is provided by brokers and traders and used as the data base for the audit trail as well as the market surveillance systems on the exchanges.

Two weeks ago I recounted my experience with previous CFTC reauthorization efforts during my tenure in the Senate, in particular, the reauthorizations of 1982 and 1986. During those debates, the CFTC from time to time proposed the addition of new authorities to the act that would better allow the Commission to assure the integrity of the futures trading process.

Not all of these proposals were accepted by the Congress. I am most interested now in a review of those debates and would welcome any information Chairman Gramm can provide to help recount the substance of any such proposals by the CFTC that were rejected and whether or not there is reason to believe that current compliance activity would be any stronger if the Congress had adopted any of them.

I have also requested the Congressional Research Service to compile a list of legislative and regulatory suggestions that have been rejected. And finally, I am not ready at this time to conclude the current systems of trading in futures contracts or of monitoring and enforcing trading practices are deficient. However, I am convinced that we will have to take a very close look at all aspects of the process before we finish reauthorization of the act in 1989.

I also think we should examine any reasonable alternatives to the current systems such as the possibility of trading futures electronically in place of the open outcry system, or some combination of these two methods so that we know the relative merits and disadvantages of the alternatives.

Once again, I welcome input from Chairman Gramm on these thoughts. We are still at a very early stage of our inquiry into futures trading practices. I am aware the industry has initiated evaluations of its own to look at the trading operations and to identify potential problems that may cause some erosion of integrity in the futures markets, and I applaud those efforts and look forward to hearing of the results.

Clearly, if there are aspects of our system that permit dishonest persons to abuse the process for their own gain, then we must all concentrate on identifying these and taking steps to root out these bad apples and see that they are severely disciplined. In this industry, the United States is way ahead of our foreign competitors, and we must vigorously protect this edge by ensuring the integrity of our markets and preserving the health of our futures exchanges for years to come. I thank you, Mr. Chairman. I will look forward to hearing from Mrs. Gramm.

The CHAIRMAN. Thank you very much. Now, Chairman Gramm, it is all over to you. You know all the questions, all the issues, and all the problems, and all you have to do is give us all the answers.

Without objection, at this point in the record, we will insert the prepared statements of Senators McConnell and Gorton.

[The prepared statements of Senators McConnell and Gorton follow:]

PREPARED STATEMENT OF HON. MITCH MCCONNELL, A U.S. SENATOR FROM KENTUCKY

Mr. Chairman, I have been looking forward to today's hearing with Wendy L. Gramm, Chairman of the Commodity Futures Trading Commission. I am certain that Chairman Gramm is anxious to work with this committee in an effort to return some of the confidence in trading futures contracts on U.S. exchanges that was lost following news reports of alleged improprieties on two exchanges.

When the Commodity Futures Trading Commission was originally authorized in 1974 it was given the responsibility for overseeing and regulating commodity futures and related trading. That responsibility has not changed, but the industry has. The current volume of contracts traded on U.S. futures exchanges is 10 times the volume that was traded the year the CFTC began 15 years ago.

Not only has the volume of trades increased, but the number of individuals associated with the industry has grown. The Commission is ordered to regulate the activities of commodity brokerage firms, all types of brokers, commodity pool operators, commodity trading advisors and futures commission merchants. This is a huge responsibility for an industry that is growing at an exponential rate.

The introduction of new contracts on domestic exchanges has caused trading volume to rise dramatically. However, futures trading is not just a domestic industry. In the past 4 years a total of 20 new exchanges have begun operation, all of which are in countries other that the United States.

I think it is vital for all concerned to realize just how large of an industry we are dealing with. While size does not preclude the industry from abiding by rigid rules and regulations, I do believe it is imperative that United States exchanges not be saddled with unfairly cumbersome rules that eliminate their ability to compete.

The concept of futures trading dates back several centuries. The oldest organized exchange in the United States started in Chicago over 140 years ago. The basic principles of futures trading are to provide stability to commodity prices and to shift some of the risk of ownership or expected use of a raw commodity to individuals who are willing to accept the risk. These basic principles should be kept in mind during our discussion.

New regulations that limited the open market bidding system that currently exists in trading pits could interfere with the true price discovery mechanism of markets. I believe it is harder to hide something when it is completely out in public view and there is nothing more out in the public view than the open outcry auctions of futures pits.

I think it is important at this stage of the hearing process to understand that while violations in fair trading practices do exist, it is not necessarily a reflection of the entire industry. There are many more honest men and women on the floor of these exchanges who make a living by being fair and upright in all trades. I do not think it is correct to also assume that violations in fair trading practices have gone completely without penalty in the past.

The Division of Enforcement within the CFTC investigates and prosecutes alleged violation in commodity futures trading. Individuals who are found in violation of rules are often severely penalized and even prohibited from trading again. There are also rules committees on futures exchanges that are charged with the responsibility of maintaining the integrity of the industry. They impose fines and penalties based on rules that are sometimes more strict than those of the CFTC.

I do not think the current system is perfect. I believe that improvements can and should be made. The technology exists to fine tune a Computerized Trade Reconstruction (CTR) audit trail to hold floor traders more accountable to each and every trade. Using the audit trail, software could be developed to detect patterns of impropriety between traders. There are other changes that should be made and this committee should investigate what alternatives are viable.

I do not envy the job that Chairman Gramm has nor do I envy the task before her in developing a strategy to keep the regulations and rule enforcement ahead of the growth curve of the industry. I feel that she should be commended for the job she has done and build now on the progress which has already been made to date.

I believe that some modifications in the present system are necessary; however I do not believe that drastic measures are called for. Carefully weighing the advantages and disadvantages of new proposals will ensure markets that are efficient and fair.

I hope that this is just one of more hearings that this committee will hold in an effort to build integrity and push U.S. futures exchanges even more to the forefront of a growing worldwide industry. I would encourage the committee to hold hearings with farmers and commercial interests who utilize the futures market for price protection. It is also important to talk to the speculators who are vital to providing liquidity to the markets. I would like to talk to the floor traders and floor brokers who are in the pits day in and day out to find out their perception of the problems and seek their advice on some practical solutions. I think we need to meet with exchange officials responsible for the conduct on their exchanges.

I do not want this to be construed as delaying or putting off making a decision. I want to emphasize how large the industry actually is and just how extensive our research of the current trading practices needs to be. I, in fact, encourage prompt action by this committee to find answers and make the necessary changes in order to restore confidence to a very vital industry in this country. I applaud the work of Chairman Gramm and look forward to working more with her and the Commodity Futures Trading Commission.

PREPARED STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM WASHINGTON

Mr. Chairman:

I commend the distinguished Chairman for calling this hearing to receive testimony from Dr. Wendy Gramm on the exchange trading practices in the commodity futures markets. I look forward to this opportunity to hear Dr. Gramm's thoughts and perspectives concerning the Commodity Futures Trading Commission's role as the oversight regulator of commodity futures and options markets in the United States.

Before Dr. Gramm joined the Commission, I had the privilege to work closely with her when she was Administrator for Information and Regulatory Affairs at the White House Office of Management and Budget (OMB), where, I might add, she did an excellent job. She is an accomplished economist with a notable record of service.

I want to commend Dr. Gramm and the Commission for its invaluable assistance and support of the Grand Jury investigation of illegal floor trading practices. Nonetheless, the reported investigation of fraud on the Chicago futures exchanges raises fundamental questions about the futures regulatory system. What we have seen happen so far here has shown that the present system certainly creates the ability for people to manipulate it and cheat at it. It is fine and wonderful to say that when we catch the guilty, we ought to put them in jail. But our responsibility is to try and see to it that we have a system which is less susceptible to being manipulated.

And so I question whether or not we ought to allow people to be trading on their own accounts whale they are operating as agents for others. And it will have to be proven to me by those who advocate that system that it isn't something which is constantly going to be manipulated, even after this particular sting is over.

In addition, I have certain questions as to whether some of the kinds of things which are being traded on futures markets are appropriate for trading at all, or are an involvement in pure speculation.

Finally, I must tell you, I still have questions as to whether or not we need two separate regulatory agencies with respect to securities.

These are just a few of my concerns, and as I stated earlier, I look forward to Dr. Gramm's testimony.

Thank you.

STATEMENT OF WENDY L. GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC, ACCOMPANIED BY ANDREA CORCORAN, DIRECTOR, DIVISION OF TRADING AND MARKETS AND DENNIS KLEJNA, DIRECTOR, DIVISION OF ENFORCEMENT

Dr. GRAMM. Thank you. I will not claim to know all the answers or all the issues or all the problems. Obviously, there is much to be learned because these markets are constantly changing and will continue to change, but let me just say today that I appreciate a chance to speak to you about our oversight function as regulator of the commodity futures and commodity options markets in the United States, and we appreciate your interest in the area.

I have provided a rather lengthy document which includes testimony and answers to questions that had been proposed earlier, and let me summarize that testimony for you today.

First of all, I understand your need for more specific information about the ongoing investigation in Chicago; however, as you mentioned, we must continue to be concerned that any action or disclosure not jeopardize the ongoing investigation. I have, however, spoken with the Justice Department to impress upon them your concerns and need for information at the earliest possible time in order that you may exercise your oversight responsibilities in a timely manner.

I would just like to summarize the Commission's regulatory functions.

The Commodity Exchange Act contemplates a two-part system of market regulation and surveillance which imposes direct self-regulatory duties upon the exchanges and vests the Commission with authority to oversee and supplement exchange self-regulation. Thus, the act combines a statutory requirement that exchanges police their own activities, markets, and members with a statutory requirement that the Commission oversee the effectiveness of such exchange self-policing activities. This system applies to the detection and prevention of trade practice abuses. It also applies to market surveillance, financial compliance, and sales practice compliance.

THE EXCHANGE SELF-POLICING REQUIREMENT

Self-regulation is intended to assure the application of market expertise and exchange resources—in addition to government resources—to maintain fair, orderly, and safe markets. The most important basis for exchange self-regulation is that exchanges generally can perform certain regulatory functions more efficiently than can a government agency. Because exchange regulatory personnel are closer to the markets, they often can move more promptly and effectively than can a government regulator. Moreover, since there are differences in the characteristics of the exchanges' products, a system of exchange self-regulation facilitates the development of regulation that is both expertly based and appropriately tailored to each exchange.

Such a system also relies on—rather than supplants—market forces and incentives to act as a check on wrongful conduct. What is very important here is that the exchanges themselves have incentives to ensure the integrity of their markets. And if their markets do not have the safety and integrity that they should, customers will go elsewhere including overseas. So that incentive structure is also another important element of the self-regulatory structure.

OVERVIEW OF TRADE PRACTICE COMPLIANCE PROGRAM

A principal feature of the Commission's oversight and exchange self-regulatory programs is trade practice surveillance. The purpose of such surveillance is to detect, deter, and provide a basis for disciplining trade practice abuses which can lessen the competitiveness of futures trading, or by which floor brokers or futures commission merchants, and others, may take advantage of customers.

Toward that end, the Commission and all domestic exchanges, as a condition of designation, have implemented trade practice surveillance programs to detect abusive trading practices on exchange floors. Exchange trade practice surveillance programs are expected to constitute the front line of regulation, subject to Commission oversight—which provides reenforcement. Important oversight mechanisms are the "public report card" provided by the rule enforcement review program, Commission trade practice investigations [TPI's] and analyses, Commission enforcement actions, and other programs such as intermittent floor surveillance and development of general guidelines and rules. Both the Commission's and the exchanges' programs of trade practice surveillance incorporate: one, computer-assisted surveillance of trading data and other records review, two, floor surveillance, and three, investigations of customer or member complaints, unusual market activity, media reports, or other matters that are brought to the compliance staff's attention.

The Commission's Division of Trading and Markets' current assessment is that all exchanges have in place the basic program components to conduct a trade practice surveillance program which generally meets the requirements of the Commodity Exchange Act and Commission regulations, and can be used to detect certain patterns of potential trading violations. The Commission also believes that its own surveillance program and the programs of the various exchanges have been effective in detecting and investigating a significant amount of trading activity for potential trading abuses. This surveillance, in turn, has resulted in referrals of such activity to the exchanges or to our own Division of Enforcement for further investigation and in generally increasing numbers of investigations and sanctions at the exchanges.

The relative effectiveness of exchange programs varies, of course, and the Division has identified, that is the Division of Trading and Markets has identified areas that are in need of improvement in particular exchange programs. Notwithstanding the foregoing, the results of the not yet complete Chicago investigation may provide new information as to the effectiveness of existing programs upon which changes can be based.

I might say that an important expected byproduct of that investigation is that it may provide new information to assist the Commission in identifying how the systems are working and what improvements might be made.

In this connection, it is very important for this committee and the public to understand that no program however refined, can detect every instance of violative activity, especially when it occurs off the trading floor, for example, some kinds of prearranged trading or other trading abuses which occur as an isolated incident.

Computer-assisted programs are most effective in detecting patterns of suspicious trading. Such programs, however, must be combined with other techniques of surveillance, and all systematic approaches, frankly, are less effective in detecting certain kinds of abuses, such as abuses which are effected through activity such as the alteration of documents and off-floor misconduct. Such abuses may be disclosed only through review of underlying records, account statements, or witness testimony, and may be reached more effectively with the special tools of the criminal justice system.

IMPORTANCE OF ENHANCED AUDIT TRAIL DATA

In 1986, the Commission also took steps to materially improve the capacity of existing exchange audit trails to identify suspicious trading activity. An audit trail is the paper trail for each trade. Generally, audit trail data include such items as customer order tickets, broker trading cards, and time and sales reports, which indicate price changes to the nearest 10 seconds or less. The amendments to Commission Regulation 1.35 requiring that a time of execution to the nearest minute be obtained for each trade were published in the Federal Register on January 14, 1986. As of 1987, all futures exchanges had implemented audit trail systems which are intended to meet that standard.

To date, the Division of Trading and Markets has completed initial rule enforcement reviews of the audit trail systems at exchanges representing 95 percent of all trading activities on futures exchanges. [See footnote 4 on page 77 of Dr. Wendy L. Gramm's prepared statement.] These reviews found that from an overall performance standpoint each exchange has developed an adequate audit trail system designed to meet the 1-minute performance standard established by Commission Regulation 1.35. The performance standard was intended to permit each market to adopt a mechanism for obtaining execution times for its particular markets.

The Commission's and the exchanges' ability to conduct effective trade surveillance has been enhanced substantially with the implementation of improved audit trail systems. Improved trade timing facilitates automated sequencing of transactions for an entire market or any subset or area of focus. The refinement of these programs permits the generation of surveillance reports with increased accuracy and, as further refinements are added and accuracy rates are improved, should further enhance the exchanges' ability to monitor and detect potential trade practice violations and initiate trade practice investigations similar to those performed by Commission itself.

COMMISSION'S EXCHANGE DATA BASE

The Commission's own system of computerized surveillance, what we call the Exchange Database System ["EDS"], was also implemented in late 1986. That system benefits from the new audit trail requirement and EDS provides the means to organize trade data relative to any futures transaction executed on an exchange. The Commission staff has designed and currently uses more than 30 programs to facilitate the detection of trading violations.

COMMISSION FLOOR SURVEILLANCE

In addition to computerized surveillance, Commission staff conducts floor surveillance on a random basis. Floor surveillance is used more to deter than to detect violative trading practices—because of the number of traders on the floor. Floor presence by regulatory staff, however, is essential to keeping the Commission apprised of routine and variant trading practices and procedures, how particular traders trade, and to obtain floor rumors and other information from exchange members and exchange or firm personnel.

COMMISSION SURVEILLANCE RESULTS

When violative trading activity is identified through Commission trade practice surveillance, several types of responses may result. In those instances where suspicious trading activity is detected, that activity is regularly referred to the relevant exchange for further investigation and may be referred to our own Division of Enforcement.

SELF-REGULATORY DISCIPLINARY PROGRAMS

Maintenance of an effective program for disciplining members who have committed trading violations at the expense of their customers or in other ways, is an essential part of the exchanges' broad self-regulatory responsibility to preserve the integrity of the marketplace and to protect the public interest. Guideline No. 2 and Commission Regulation 1.51 require that exchanges have in place procedures to take prompt, effective disciplinary actions against members for rule violations. In the rule enforcement reviews conducted from 1986 through 1988, the Division of Trading and Markets generally determined that the exchanges are fulfilling their self-regulatory responsibility with respect to the administration of effective disciplinary programs. In most instances, the Division found that the exchanges imposed a number of significant sanctions that were reasonably calculated to deter future trading abuses. [See footnote 8 on page 80 of Dr. Wendy L. Gramm's prepared statement.]

OTHER FUNCTIONS OF THE CFTC

In addition to oversight programs, which encompasses all of the Commission's regulatory compliance and enforcement activities—I have been focusing on trade practice surveillance in my testimony—the Commission directly: provides a reparations forum and oversees customer arbitration programs; performs market surveillance; and brings enforcement cases of various types.

We also have a strong financial surveillance program as well as a sales practice audit program. So trade practice investigations and surveillance is just one part of a large number of other things the Commission does.

ENFORCEMENT

I would like to spend a minute on enforcement before I close.

The Commission's enforcement program seeks to ensure compliance with the act and Commission regulations through civil and administrative enforcement actions and coordinated law enforcement activities with Federal, State, and local officials. Commission enforcement actions cover such diverse and complex violations as price manipulation; trade practice abuse; sales practice fraud; sale of illegal instruments; violation of financial integrity regulations and violation of reporting and recordkeeping requirements. Enforcement investigations are conducted based on information developed by the Division of Enforcement or referred by other Commission divisions.

The sanctions that may be imposed in Commission proceedings include a Commission order directing a respondent to cease and desist from further violations, revoking or suspending a respondent's registration with the Commission, prohibiting a respondent from trading on Commission regulated markets, and imposing civil monetary penalties of up to $100,000 per violation. Injunctive actions may result in court orders enjoining illegal conduct, appointing a receiver, and imposing other equitable relief such as rescission of illegal contracts and restitution of customer funds. Criminal violations of the act—which are prosecuted by the Department of Justice—can result in fines of up to $500,000 per violation and imprisonment of up to 5 years. In addition to the Commodity Exchange Act, criminal authorities often use mail and wire fraud statutes to prosecute commodity-related fraud.

Since January 1983, the Commission has brought trade practice enforcement actions against 97 individuals and firms in 38 proceedings.

The Commission, of course, does not have criminal enforcement authority. To assure effective criminal investigation and prosecution, the Commission has long encouraged criminal law enforcement through its education program and through participation in task forces and working groups, such as the Securities and Commodities Fraud Working Group. In our education program we have spoken to, and taught, some 1,500 law enforcement authorities at Federal, State and local levels, and have been instrumental, for example, in setting up Securities and Commodities Fraud Boiler Room Task Forces in southern California. In addition, the Commission's Enforcement Division routinely cooperates with other Federal and State law enforcement agencies, including the Department of Justice. For example, the Commission recently cooperated with the U.S. Attorney in Chicago in bringing indictments against 18 former employees of First Commodity Corporation of Boston in a matter that began as an extensive Commission investigation and civil administrative action. Accordingly, the Commission welcomes the increased emphasis on prosecuting commodity-related fraud recently announced by the Department of Justice.

CONCLUSION

The Commission believes that its existing regulatory authority is sufficient to discharge its responsibilities to protect the integrity of U.S. futures and options markets. To the extent that any improprieties or abuses are found in the course of the ongoing investigation warrant changes in existing programs, systems or rules, the Commission has publicly stated that it stands ready to take such actions as my be appropriate to address those circumstances. Furthermore, should the investigation develop evidence of problems which the Commission believes would require legislative solutions, we will promptly inform the committee and provide recommendations.

Thank you very much, and you have raised, Mr. Chairman and Senator Lugar, a number of other questions that we would be happy to address, if not now, at some later date as well, with some time.

[The prepared statement and prepared material of Dr. Gramm follow:]

PREPARED STATEMENT OF DR. WENDY LEE GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. Chairman and members of the committee, thank you for asking me to testify today concerning the Commodity Futures Trading Commission's role as the oversight regulator of commodity futures and options markets in the United States. The Commission appreciates your interest in this area and the role and responsibilities of this Committee in overseeing the regulatory functions of the Commission.

Preliminarily, I understand your need for more specific information about the ongoing investigation in Chicago; however, the Commission remains concerned about any action it might now take that could jeopardize an ongoing investigation. I have spoken with the Justice Department to impress upon them your concerns and need for information at the earliest possible time in order that you may exercise your oversight responsibilities in a timely manner.

Now let me turn to an overview of the Commission's regulatory functions. As you know, the Commission has responsibility for supervising:

—14 futures and options markets located in Chicago, New York, Kansas City, Philadelphia, Minneapolis and San Francisco (although no contract has ever traded on the Pacific Board of Trade),
—more than 370 licensed commodity firms (futures commission merchants),
—approximately 7,000 floor brokers,
—nearly 1,700 introducing brokers, and
—together with salespersons and account managers, overall a total of approximately 70,000 licensed futures professionals.

Over 290 million transactions occurred in these markets in 1988.

The Commission uses every tool at its disposal to monitor the markets under its jurisdiction. For example, it:

—maintains oversight of the self-policing efforts of the exchanges and the National Futures Association ("NFA") (which has responsibility for supervising firms that are not members of an exchange);

—conducts direct surveillance of markets and market professionals;

—makes referrals to the exchanges for investigation and disciplinary action;

—brings enforcement actions both before the Commission's administrative law judges and the Federal courts;

—assists and coordinates with other civil and criminal enforcement authorities at the state and federal levels; and

—engages in cooperative arrangements with foreign authorities for enforcement and information-sharing purposes.

The Commodity Exchange Act ("Act") contemplates a two-part system of market regulation and surveillance which imposes direct self-regulatory duties upon the exchanges and vests the Commission with authority to oversee and supplement exchange self-regulation. Thus, the Act combines a statutory requirement that exchanges police their own activities, markets, and members with a statutory requirement that the Commission oversee the effectiveness of such exchange self-policing activities. This system applies to the detection and prevention of trade practice abuses. It also applies to market surveillance, financial compliance and sales practice compliance.

THE EXCHANGE SELF-POLICING REQUIREMENT

Self-regulation is intended to assure the application of market expertise and exchange resources—in addition to government resources—to maintain fair, orderly and safe markets. The most important basis for exchange self-regulation is that exchanges generally can perform certain regulatory functions more efficiently than can a government agency. Because exchange regulatory personnel are closer to the markets, they often can move more promptly and effectively than can a government regulator. Moreover, since there are differences in the characteristics of exchanges' products, a system of exchange self-regulation facilitates the development of regulation that is both expertly based and appropriately tailored to each exchange.

Such a system also relies on—rather than supplants—market forces and incentives to act as a check on wrongful conduct. In particular, exchanges have incentives to ensure the integrity of their markets.

It is also important to remember that self-regulation is complemented by Commission oversight. As overseer of futures market regulation, the Commission is responsible for ensuring the economic utility of futures markets by encouraging their competitiveness and efficiency, by assuring their integrity, and by protecting market participants against manipulation, abusive trade practices, and fraud in the marketplace.

Thus, the goal of self-regulation under Commission oversight is more efficient regulation of the markets at a lower cost. The compliance staffs of the self-regulatory organizations—the commodity exchanges and National Futures Association—consist of approximately 482 persons with a combined budget of approximately $33 million for 1988. These exchange compliance staff assisted by computer surveillance systems maintained at each exchange. This self-regulatory structure allows the Commission to devote its resources to oversight and to the other tasks required to administer the Commodity Exchange Act.[1]

The Commodity Exchange Act and regulations promulgated by the CFTC require that before an exchange may be "designated" or approved as a futures market, and to maintain such designation, it must satisfy requirements designed to ensure that the exchange will be able to police its markets and provide customer protection. As an example of these requirements, the Commission explicitly requires exchanges to have programs which cover:

—market surveillance,

—surveillance of trading,

—propriety of books and records,

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[1] For example, in a December 1985 report to Congress, the Commission estimated that for fiscal years 1983, 1984 and 1985, NFA regulatory activities alone resulted in cumulative direct savings of $3,549,800 to the Commission and in costs avoided by the federal government (or additional appropriations the Commission would have been obliged to request) of $16,206,400. In NFA's separate report to Congress on its first three years of operation, NFA stated that "[t]he federal government has realized 'hard dollar' savings of $35,373,572 as a result of NFA's operations, with substantial in-kind contributions from NFA members and volunteer arbitrators."

—investigation of complaints and alleged trade practice and other violations, and
—monitoring and auditing for satisfaction of financial requirements.

Commission rules also impose specific requirements upon the exchanges in a number of key areas. For example, the Commission specifically requires exchanges to have rules in place which address maintenance of adequate trading records, price information, financial compliance, misuse of material non-public information, trading ahead of customers and other trading abuses, and price manipulation.

As an express statutory condition of designation and continuing operation, each U.S. futures market must enforce all of the rules of that market which have been approved or permitted to become effective by the Commission. To police its markets, an exchange must maintain a continuing, affirmative compliance program with sufficient mechanisms to deter, detect, and sanction practices which tend to lessen the competitiveness of trading or take advantage of customers, and otherwise to secure compliance with relevant provisions of the Commodity Exchange Act and Commission regulations. Commission Rules 1.51 and 1.52, respectively, require futures markets designated by the Commission to use due diligence to maintain such programs. Guideline 2, (May 13, 1975) (CCH Comm. Fut. L. Rep. ¶ 6430) issued by the Commission in 1975, states that due diligence means "proper, sufficient and reasonable care" and "proper, sufficient and reasonable effort" in carrying out a program which results in the taking of prompt, effective disciplinary action for any violation. The specific standards applied by the Commission to exchange compliance programs continue to evolve in order to address new market conditions, new products, and new technology.

THE OVERSIGHT REQUIREMENT

As you know, the Congress did not commit the markets to self-policing alone. The Commodity Exchange Act requires Commission oversight. Accordingly, in adopting the Act in 1974, Congress found that "[s]elf-regulation is a commendable and noble concept and useful in such a complex atmosphere as surrounds futures trading," but also recognized that self-regulation needs the incentive provided by government oversight and "cannot continue to function without a strong Federal regulatory umbrella." [2] Of course, it also is important that government oversight be balanced. Effective and non-duplicative self-regulation is dependent on the Commission's responsible exercise of its power.

Self-regulation has long been a feature of financial markets where close scrutiny is a necessary condition of doing business. The following statement on the importance of self-regulation as used in the securities markets describes the concept well, and is as relevant today as it was 15 years ago:

> There is no reason for any less emphasis today on the importance of self-regulatory initiative and responsibility. The Government's role calls for vigilant awareness of what is going on in the marketplaces and of developments and trends in the industry; constant liaison with the self-regulatory agencies and cognizance of the policies and methods utilized in the conduct of self-regulation; but a high degree of restraint in exercising the ultimate power to alter or supersede their actions in particular situations. Ample power in reserve—"big stick" or "shotgun"—is the ultimate safeguard, not the medium for domination.[3]

Through effective oversight, the Commission enables domestic futures markets to better serve their unique function of providing a mechanism for price discovery and a means of hedging price risks.

OVERVIEW OF TRADE PRACTICE COMPLIANCE PROGRAMS

A principal feature of Commission oversight and exchange self-regulatory programs is trade practice surveillance. The purpose of such surveillance is to detect, deter, and provide a basis for disciplining trade practices which can lessen the competitiveness of futures trading or by which floor brokers or futures commission merchants may take advantage of customers.

Toward that end, the Commission and all domestic exchanges as a condition of designation have implemented trade practice surveillance programs to detect abusive trading practices on exchange floors. Exchange trade practice surveillance programs are expected to constitute the front line of regulation, subject to Commission oversight—which provides reenforcement. Important oversight mechanisms are the "public report card" provided by the rule enforcement review program, Commission trade practice investigations ("TPI's") and analyses, Commission enforcement actions, and other programs such as intermittent floor surveillance and development of general guidelines and rules. Both the Commission's and the exchanges' programs of trade practice surveillance incorporate:

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[2] H.R. Rep. No. 975, 93d Cong., 2d Sess. 48 (1974).

[3] 4 SEC Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 693 (1983).

(1) computer-assisted surveillance of trading data and other records review,

(2) floor surveillance, and

(3) investigations of customer or member complaints, unusual market activity, media reports, or other matters that are brought to compliance staff's attention.

The Division of Trading and Markets' current assessment is that all exchanges have in place the basic program components to conduct a trade practice surveillance program which generally meets the requirements of the Commodity Exchange Act and Commission regulations and can be used to detect certain patterns of potential trading violations. The Commission also believes that its own and the various exchange programs have been effective in detecting and investigating a significant amount of trading activity for potential trading abuses. This surveillance, in turn, has resulted in referrals of such activity to the exchanges or the Division of Enforcement for further investigation and in generally increasing numbers of investigations and sanctions at the exchanges.

These assessments as to the design and execution of exchange compliance programs are a necessary precondition of the Commission's permitting the markets to continue to function as a matter of law. The relative effectiveness of exchange programs varies, and the Division has identified areas that are in need of improvement in particular exchange programs. Notwithstanding the foregoing, the results of the not yet complete Chicago investigation may provide new information as to the effectiveness of existing programs upon which changes can be based.

In this connection, it is very important for this Committee and the public to understand that no program, however refined, can detect every instance of violative activity, especially when it occurs off the trading floor (as may occur in some prearranged trading), or when it occurs as an isolated incident. Further, it must be emphasized that records review can disclose only certain possible trading violations. Additional investigation ordinarily is required to determine whether evidence of such potential violations should be presented to an exchange disciplinary committee or form the basis for a Commission enforcement action.

Computer-assisted programs are most effective in detecting patterns of activity among traders or groups of traders which may be indicative of certain trading abuses such as noncompetitive trading, accommodation trading, or wash trading. Of course, such programs can only detect patterns of suspicious trading for the periods of trading activity to which they are applied. As a practical matter and in order to achieve the most cost-effective program, the Commission and the exchanges have conducted selective surveillance, rotating areas of concentration based on volume, market events, and other information. Computer-assisted trade practice surveillance programs must be combined with other techniques of surveillance, and all systematic approaches are less effective in detecting abuses effected through activity such as alteration of documents and off-floor misconduct. Such abuses may be disclosed only through review of underlying records, account statements, or witness testimony, and may be reached most effectively with the special tools of the criminal justice system.

The Commodity Exchange Act and the regulations thereunder require the self-regulatory organizations (exchanges) to have affirmative compliance programs. This means that they cannot just await complaints about floor practices, but rather must continuously examine their markets for abusive activity. To be in compliance, a trade practice surveillance program must independently generate reviews of trading activity designed to detect suspicious trading for further investigation and not just pursue matters initially identified by a customer or member complaint or through other external sources of information.

Commission staff, since 1982, has emphasized the development of computer-assisted trade practice surveillance capabilities by both the Commission and the exchanges and through its "public report card" review process, has made recommendations, where appropriate, to improve those systems. Such systems address the practical impossibility of reviewing the markets effectively through manual examination of trade registers and the limitations of relying exclusively on tips, market events, rumors, or other sources to identify matters for further investigation. A computer system can be used to identify quickly potential trading abuses both in the first instance or based on other information. Computer systems therefore enable staff resources to be deployed cost-effectively.

More particularly, these computerized systems enable exchange and Commission staff to identify potentially improper trade practices and to analyze suspicious trading patterns without engaging in the time-consuming task of requesting, gathering, and analyzing original trade documents not pertinent to the specific activity to be investigated. Later in the investigative process, original trading records will be requested. Computer systems permit focused document requests based on analysis of particular transactions. Such documents can be analyzed by Commission or exchange staff more quickly than if original trading documents have to be sampled to identify improper activity or voluminous records need to be collected and reviewed in order to isolate the problem.

By the end of fiscal 1986, almost all exchanges had some form of computer-assisted trade practice surveillance system in place. The Commission routinely reviews the effectiveness of these systems in the course of rule enforcement reviews. In those reviews, the Commission staff has made recommendations for improvements, including that the exchanges regularly review the parameters used in their systems to identify abuses to assure that they generate data which in fact lead to the detection of rule violations and disciplining of violators.

IMPORTANCE OF ENHANCED AUDIT TRAIL DATA

In 1986, the Commission also took steps to materially improve the capacity of existing exchange audit trails to identify suspect trading activity. An audit trail is the paper trail for each trade. The information contained in that paper trail can be used to reconstruct trading. Generally, audit trail data include such items as customer order tickets, broker trading cards, and time and sales reports, which indicate price changes to the nearest 10 seconds or less. The amendments to Commission Regulation 1.35 requiring that a time of execution to the nearest minute be obtained for each trade were published in the *Federal Register* on January 14, 1986. As of 1987, all futures exchanges had implemented audit trail systems which are intended to meet that standard. Such systems are light years ahead of old systems which relied solely on 30-minute bracket data to identify trading patterns for investigation and to reconstruct market activity.

To date, the Division of Trading and Markets has completed initial rule enforcement reviews of the audit trail systems at exchanges representing 95 percent of all trading activity on futures exchanges.[4] These reviews found that from an overall performance standpoint each exchange has developed an adequate audit trail system designed to meet the one-minute performance standard established by Commission Regulation 1.35. The performance standard was intended to permit each market to adopt the mechanism for obtaining execution times for its particular markets.

The Commission's and the exchanges' ability to conduct effective trade surveillance has been enhanced substantially with the implementation of improved audit trail systems. Improved trade timing facilitates automated sequencing of transactions for an entire market or any subset or area of focus. The refinement of these programs permits the generation of surveillance reports with increased accuracy and, as further refinements are added and accuracy rates are improved, should further enhance the exchanges' ability to monitor and detect potential trade practice violations and initiate TPI's similar to those performed by Commission staff. In that regard, the Commission's Division of Trading and Markets has written to the exchanges requesting a timetable for further audit trail system performance improvements.

COMMISSION'S EXCHANGE DATA BASE

The Commission's own system of computerized surveillance, the Exchange Database System ("EDS") also was implemented in late 1986. That system benefits from the new audit trail, for it is fed by exchange data.[5] Commission staff uses EDS to perform surveillance activities, primarily at the regional offices, through the conduct of TPI's. EDS provides the means to organize trade data relative to any futures transaction executed on an exchange and uses more than 30 programs designed by CFTC staff to facilitate detection of trading violations.

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[4] Specifically, those reviews were the New York Mercantile Exchange ("NYMEX"), Kansas City Board of Trade ("KCBT"), Commodity Exchange, Inc. ("COMEX"), Minneapolis Grain Exchange ("MGE"), Chicago Mercantile Exchange ("CME") New York Cotton Exchange ("NYCE") and Chicago Board of Trade ("CBT") (including affiliate exchanges, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange).

[5] Data stored in the system routinely are obtained on a monthly basis from the exchanges' trade register tapes, which are required to be maintained by the exchanges under Commission Regulation 1.35(e) and, of course, may be obtained at any other time on an as needed basis.

The EDS programs (and most exchange programs) are designed to detect trade practice violations such as—disclosure of orders, taking the other side of customer orders, wash trading, accommodation trading, bucketing, trading ahead of customer orders, and certain types of prearranged trading. For example, if there is concern regarding preferential trading between certain members or groups of members, the system can generate a report showing all of the trades made by a specific individual with another member or group of members for any period of time. To identify possible abuses relating to customer orders, the system can generate a report which time-sequences all trades of a dual trader (one who executes customer orders and also trades for his own account) to determine whether that broker traded at a better price for his own account at or near the time he executed customer orders. Such surveillance may also detect overlapping trade practice violations such as accommodation or wash trading.

Just as the Commission has recommended improvements to the exchanges, the Commission continuously has reevaluated and modified its program as it has gained experience with the system and as specific situations warrant.

COMMISSION FLOOR SURVEILLANCE

In addition to computerized surveillance, Commission staff conducts floor surveillance on a random basis. Floor surveillance is used more to deter than to detect violative trading practices—because of the number of traders on the floor. Floor presence by regulatory staff, however, is essential to keeping apprised of routine and variant trading practices and procedures, how particular traders trade, and to obtain floor rumors and other information from exchange members and exchange or firm personnel. Current resources do not permit a major commitment to floor surveillance and there is no way to measure accurately the extent of its deterrent effect using surveillance techniques available to civil regulatory and self-regulatory authorities.

COMMISSION SURVEILLANCE RESULTS

When activity is identified through Commission trade practice surveillance several types of responses may result. In those instances where suspicious trading activity is detected, that activity is regularly referred to the relevant exchange for further investigation and may be referred to the Commission's Division of Enforcement. The Division of Trading and Markets initiated 14 trade practice investigations of activity at the CBT during calendar year 1986, 24 during 1987, and 10 in 1988; and initiated 10, 22, and 20 trade practice investigations of the CME for the same respective time periods. As a result of these activities, Division staff referred four matters concerning trading at the CBT or CME to the Division of Enforcement during fiscal year 1986,[6] six during 1987, and three during 1988. These referrals involved 44 traders and seven firms in the aggregate. The Division referred other matters to the CBT and CME for further investigation—six to the CME in calendar year 1986, two in 1987, and two in 1988; and eight to the CBT in 1986, five in 1987, and four in 1988. These matters involved 48 traders and 23 firms in the aggregate. During the same time period, the Division also referred six customer complaints it received to the CBT and CME. Moreover, illegal floor practices can be the subject of criminal prosecution. For example, the United States Attorney in Chicago recently prosecuted an action involving floor conduct on the CBT with the assistance of Commission staff.

In some cases where persistent types of activities were found proposed rulemaking was undertaken. For example, as mentioned earlier, to refine the records available for analysis the Commission adopted improved audit trail requirements in 1986; to address persistent trading by unregistered persons for customers the Commission adopted, in 1985, a rule requiring exchanges to be responsible for assuring that persons engaging in floor brokerage activities were properly registered.

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[6] The Division referred a total of seven trade practice matters to the Division of Enforcement concerning all exchanges during fiscal year 1986.

SELF-REGULATORY SURVEILLANCE PROGRAMS

The exchanges conduct the first-line surveillance programs. For example, the CME's computerized trade surveillance system ("CATSS") generates reports which CME staff use to assist in detecting trading abuses on a daily basis. CATSS generates reports that focus specifically on certain trade practice violations such as trading ahead and trading against customer orders. A similar computerized surveillance system is used at the CBT. The CBT's Trade Practice Investigation program is designed to review a specific number of contracts each month and to detect potential trade practice violations which include trading ahead, trading against customer orders, as well as other types of noncompetitive trading. The review of these data, combined with underlying trading documents, forms the basis for further investigations of members' trading activity.

In addition, the exchanges also maintain active floor surveillance programs and investigate complaints. Exchanges conduct such surveillance on a random basis, during particularly active periods of the day such as the opening and close, and continuously during periods of unusual volatility. This surveillance provides the exchanges with useful market information and may deter trading abuses.

ASSESSMENT OF SRO SURVEILLANCE-RELATED SYSTEMS

Commission staff reviews of exchange programs includes consideration of whether:

—routine surveillance activities result in the initiation of investigations of a variety of substantive trade practice abuses,

—whether the files on those and other investigations *e.g.*, customer complaints) demonstrate that exchange staff thoroughly examined all trading activity and individuals or firms potentially relevant to the inquiry, and

—whether exchange files support the exchange's conclusions or reveal additional potential abuses which were not investigated or additional investigative actions which should have been undertaken by the exchange.

Although it is difficult to assess the effectiveness of these programs because the actual extent of trading abuses is not determinable, it is possible to examine the activities undertaken by the exchange and to quantify the results of that activity. In this regard, the Commission has ascertained that the CBT, CME, and NYMEX, the three largest futures exchanges, initiated the following numbers of trade practice investigations from 1986–1988: [7]

	1986	1987	1988
CBT	27	15	26
Internal	4	2	10
External	23	13	16
CME	151	146	128
Internal	70	38	29
External	81	108	99
NYMEX	134	92	130
Internal	93	62	87
External	41	30	43

The rule enforcement review process has resulted in continuing, significant improvements in exchanges' enforcement programs. The Commission's recommendations have addressed such areas:

—as the automation of surveillance and enhancements to existing computer systems, described in detail above,

—improved recordkeeping,

—increased surveillance of particular types of conduct,

—greater coverage of exchange activities,

—adequate attention to high volume contracts,

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[7] For purposes of this chart, internal and external refer to whether the source of the investigation was exchange data or staff expertise or information received by the exchange from third party sources, such as complaints.

—more thorough investigation of potentially violative activity,
—stricter enforcement through imposition of penalties,
—application of sanctions to all persons implicated in the violative trading scheme identified, and
—more aggressive deterrence of recidivism.

In the case of audit trails, rule enforcement review reports have recommended changes which address:

(1) the accuracy of data input into the system,
(2) verifiability of times obtained,
(3) alteration of data after the fact, and
(4) the logic of computer systems.

In its reviews the Division has particularly recommended improvements with respect to timing of locals' trades.

For the most part, exchanges have responded affirmatively to the Division's recommendations. For example, there generally has been a marked increase in the levels of sanctions imposed on members found to have violated exchange rules. Similarly, there generally have been substantial increases in the resources and personnel dedicated to exchange compliance activity. The Commission continually reevaluates its surveillance systems. Similarly, under the Commission's regulations, effective self-regulation involves the assessment and upgrading of exchange surveillance programs to cover new products and market situations. The exchanges also have responded positively to the Division's audit trail recommendations.

Exchanges also can enhance their ability to conduct trade practice surveillance by promulgating rules which prohibit specific conduct that otherwise would be legal. For example, in 1986, the CME made major rule revisions with respect to trading in its S&P 500 pit that, among other things, limit dual trading. Sometimes, if it appears that one exchange's reforms are of general interest, Commission staff will advise all other exchanges to consider such actions in connection with review of their own programs.

SELF-REGULATORY DISCIPLINARY PROGRAMS

Maintenance of an effective program for disciplining members who have committed trading violations, at the expense of their customers or otherwise, is an essential part of the exchanges' broad self-regulatory responsibility to preserve the integrity of the marketplace and to protect the public interest. Guideline No. 2 and Commission Regulation 1.51 require that exchanges have in place procedures to take prompt, effective disciplinary actions against members for rule violations. In the rule enforcement reviews conducted from 1986 through 1988, the Division generally determined that the exchanges are fulfilling their self-regulatory responsibility with respect to the administration of effective disciplinary programs. In most instances, the Division found that the exchanges imposed a number of significant sanctions that were reasonably calculated to deter future trading abuses.[8]

In analyzing the various exchange disciplinary programs, the Division examines the following: (1) timeliness of the disciplinary process; (2) whether decisions were supported by the evidence; (3) the adequacy of the sanction, including the considerations in levying sanctions, *e.g.*, the nature of the violation (technical or substantive), the deterrent effect of the action, nature of damages or injury, and whether the same member repeatedly has committed the same or similar trade practice abuses.

The disciplinary programs of the various futures exchanges are administered in accordance with respective exchange rules which have been adopted and implemented in compliance with Part 8 of the Commission's regulations. Part 8 sets forth the standards which an exchange must follow in establishing, *inter alia*, procedures for adjudicating possible rule violations. Generally, the standards contained in Part 8 are designed to ensure that exchange disciplinary proceedings are conducted with procedural due process in a thorough, impartial and expedient manner. If it is alleged or appears that the disciplinary proceeding was not conducted in accordance with Part 8, the Commission may review the disciplinary action under Part 9 of its regulations. Those regulations recently have been substantially amended to increase the opportunity for aggrieved persons to obtain Commission review of exchange disciplinary actions.

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[8] The Minneapolis Grain Exchange ("MGE") was an exception. In its 1988 rule enforcement review, the Division found that MGE had conducted no investigations of trade practice violations and, thus, had taken no disciplinary actions in this regard. As a result, an administrative proceeding was brought against the Exchange by the Commission's Division of Enforcement. That proceeding was settled, and, among other things a civil penalty of $30,000 was assessed.

Statistics compiled by the Division from disciplinary notices filed by the exchanges, which provide an overview of the disciplinary actions taken by all exchanges from 1986 to 1988 indicate that monetary sanctions imposed by all exchanges for trade practice violations totaled approximately $1,261,700 in 1986, $2,712,625 in 1987, and $1,751,672 in 1988.[9] These fines are in addition to those levied for other types of violations, such as those involving market surveillance or financial requirements. Further, exchanges have sanctioned trade practice violations with suspensions ranging from several days to several years and with expulsions. From 1986 to 1988, the various exchanges suspended 123 members and expelled 20 members.

In most cases, exchanges gave due consideration to recidivism. To the extent that schedules of fines exist for certain rule violations at the various exchanges these generally provide for increased fines based on the number of offenses committed. Also, investigation reports contained in case files presented to disciplinary committees generally noted prior incidents of trading abuses so that recidivism could be considered in the determination of an appropriate penalty. Where sanctions imposed did not reflect such considerations, the Division has been critical of the exchange. Notably, in 1987 and 1988, exchanges in New York and Chicago imposed sanctions for trade practice, financial, and market surveillance violations on 675 individual members and member firms, of which 207 members (31 percent) could be characterized as major market participants, based generally upon either extensive trading activity or positions on exchange committees.

CURRENT DEVELOPMENTS IN SELF-REGULATORY TRADE PRACTICE SURVEILLANCE PROGRAMS

Shortly after allegations of the criminal investigation of trading practices on the Chicago futures markets became known, exchanges began to take action to address issues which those allegations suggested. The CME and the CBT directed special committees to make recommendations for improvements in market structure and how markets are policed that would enhance customer protection and detection, sanction, and prevention of trading abuses.

Based on these developments, the Commission's Division of Trading and Markets wrote to those exchanges on February 7, suggesting a list of issues for their consideration in the course of evaluating their programs and markets. The Division also sent that list of issues to all other exchanges since their self-regulatory systems might also benefit from refinements in their markets. Subsequently, the other futures exchanges have responded by forming internal systems review committees as well.

Those committees have numerous potentially important proposals under consideration. In fact, they already have begun to yield results. For example, as a result of this process the CBT has approved a number of improvements in its audit trail-related systems. Those improvements, which the Exchange projects will be fully implemented later this year, include pickup of trading cards every hour followed by clearing firm trade submission within the following hour and 50 percent shorter time brackets and special brackets for the beginning and ending of the trading day. The Commission staff intend to continue to work closely with the exchanges in identifying and implementing additional reforms which may be suggested by further developments and in testing the efficacy of the measures taken.

OTHER FUNCTIONS OF THE CFTC

In addition to oversight, which encompasses all of the Commission's regulatory compliance and enforcement activities, the Commission directly:
—provides a reparations forum and oversees customer arbitration programs,
—performs market surveillance, and
—brings enforcement cases of various types.

MARKET SURVEILLANCE

The CFTC employs a comprehensive Market Surveillance system which is designed to maintain freely competitive markets by detecting and preventing threats of price manipulation or other major market disruptions caused by abusive trading practices. CFTC Market Surveillance staff monitors daily, for all active futures and options contracts, the activities of large traders, key price relationships, and relevant supply and demand factors in a continuous review for potential market problems. The staff coordinates its activities with their exchange counterparts and works with them to resolve any potential market threats that may develop. Through weekly briefings, the Commissioners and senior CFTC staff are kept informed of potential problems and significant market developments so they will be prepared to take prompt regulatory action when necessary.

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[9] Data by exchange can be found attached as Appendix A.

ENFORCEMENT

The Commission's enforcement program seeks to ensure compliance with the Act and Commission regulations through civil and administrative enforcement actions and coordinated law enforcement activities with federal, state and local officials. Commission enforcement actions cover such diverse and complex violations as price manipulation; trade practice abuse; sales practice fraud; sale of illegal instruments; violation of financial integrity regulations and violation of reporting and recordkeeping requirements. Enforcement investigations are conducted based on information developed by the Division of Enforcement or referred by other Commission divisions.

The sanctions that may be imposed in Commission proceedings include a Commission order directing a respondent to cease and desist from further violations, revoking or suspending a respondent's registration with the Commission, prohibiting a respondent from trading on Commission regulated markets, and imposing civil monetary penalties of up to $100,000 per violation. Injunctive actions may result in court orders enjoining illegal conduct, appointing a receiver, and imposing other equitable relief such as rescission of illegal contracts and restitution of customer funds. Criminal violations of the Act can result in fines of up to $500,000 per violation and imprisonment of up to 5 years. In addition to the Commodity Exchange Act, criminal authorities often use mail and wire fraud statutes to prosecute commodity-related fraud.

Since January 1983, the Commission has brought trade practice enforcement actions (including statutory disqualification proceedings against floor brokers) against 97 individuals and firms in 38 proceedings. As a result of these actions, the Commission has assessed over $2,705,000 in civil penalties (a small proportion of which is subject to appeal), has revoked, suspended, or denied the registrations of 38 persons or firms (5 subject to appeal), has revoked or suspended the trading privileges of 49 persons or firms (5 subject to appeal), and has entered 69 cease and desist orders (3 subject to appeal). In certain cases, the Commission also has obtained specific undertakings from respondents to address alleged compliance and supervision deficiencies.

The Commission, of course, does not have criminal enforcement authority. To assure effective criminal investigation and prosecution, the Commission has long encouraged criminal law enforcement through its education program and through participation in task forces and working groups, such as the Securities and Commodities Fraud Working Group. In addition, the Commission's Enforcement Division routinely cooperates with other federal and state law enforcement agencies, including the Department of Justice. For example, the Commission recently cooperated with the U.S. attorney in Chicago in bringing indictments and information against 18 former employees of First Commodity Corporation of Boston in a matter that began as an extensive Commission investigation and civil administrative action. Accordingly, the Commission welcomes the increased emphasis on prosecuting commodity-related fraud by the Department of Justice.

CONCLUSION

The Commission believes that its existing regulatory authority should be sufficient to discharge its responsibilities to protect the integrity of U.S. futures and options markets. To the extent that any improprieties or abuses found in the course of the ongoing investigation warrant changes in existing programs, systems or rules, the Commission has publicly stated that it stands ready to take such actions as may be appropriate to address those circumstances. Furthermore, should the investigation develop evidence of problems which the Commission believes would require legislative solutions, we will promptly Inform the Committee and provide recommendations.

[Attachments follow:]

APPENDIX A.—MONETARY SANCTIONS IMPOSED BY EXCHANGES FOR TRADE PRACTICE VIOLATIONS, 1986–1988 [1]

	1986	1987	1988
CBT	$180,500	$190,100	$287,000
CME	285,400	[2] 2,098,925	717,250
COMEX	441,450	330,200	592,500
NYMEX	95,000	0	32,500
CSC	147,275	63,925	47,500
NYCE	23,550	9,225	1,400
NYFE	23,125	6,750	72,022
KCBT	65,000	13,500	1,500
MACE	400	0	0

[1] The remaining exchanges imposed no sanctions during this period.
[2] This amount includes 14 sanctions of $50,000 or more.

Commodity Futures Trading Commission,
Washington, DC, *March 7, 1989.*

Senator Patrick Leahy,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, Washington, DC.

Dear Senator Leahy: In preparation for the Committee's consideration of the reauthorization of the Commodity Futures Trading Commission, enclosed are materials responsive to the questions posed in your February 9, 1989 letter and requested in the attachment to that letter. For the most part, those responses are contained in the attached 64-page document with enclosed tables. The questions included in your letter are designated as Q.1., Q.2., and Q.3. and responses to the list of materials are designated as items (I.)2.–11. To the extent possible, those responses contain pertinent statistical data. Also enclosed are copies of the most recent rule enforcement reviews of each exchange, as requested in item 1., except for those reviews pertaining to financial and sales practice exchange programs. Those reviews will be forwarded to you tomorrow with my testimony for the March 9 hearing.

I hope that this information will be helpful to the Committee in its deliberations. The Commission is prepared to provide the Committee with any further information which may be of benefit during the reauthorization hearings.

Sincerely,

Wendy L. Gramm,
Chairman.

[Responses to the questions posed in the February 9, 1989 letter and requested in the attachment to that letter follow:]

Q.1. How effective are currently-used surveillance techniques in detecting abusive trading practices on Exchange floors?

A.1. The Commission and all domestic exchanges have implemented trade practice surveillance programs designed to detect abusive trading practices on exchange floors. Exchange trade practice surveillance programs are expected to constitute the first line of regulation, subject to Commission oversight through its rule enforcement review program, other Commission oversight mechanisms such as trade practice reviews and floor surveillance and the Commission's own enforcement program. Both the Commission's and the exchanges' programs of trade practice surveillance incorporate: (1) computer-assisted surveillance of trading and other trade records review, (2) floor surveillance, and (3) investigations of customer or member complaints, unusual market activity, media reports, and other matters that are brought to compliance staff's attention.

The Commission's Division of Trading and Markets' (Division) current assessment is that all exchanges have in place the basic components to conduct a trade practice surveillance program which meets the requirements of the Commodity Exchange Act and Commission regulations and can be used to detect certain patterns of potential trading violations. The exchanges vary in the relative effectiveness of their programs, and the Division, through its rule enforcement review process, has identified areas in need of improvement in particular exchange programs. Effectiveness is measured both in terms of the capability of systems in place and the results obtained through use of such systems. In any event, neither exchange nor Commission routine surveillance can detect every instance of violative activity, especially when it occurs off the trading floor (as may occur in some prearranged trading), or when it occurs as an isolated incident.

With respect to systems capability, Commission staff, since 1982, has emphasized the development of computer-assisted trade practice surveillance programs. A primary benefit of such systems is that they assist exchange and Commission staff in detecting possible trade practice abuses and analyzing suspicious trading patterns expeditiously and efficiently without engaging in the time-consuming task of requesting, gathering, and analyzing original trade documents not pertinent to the specific activity to be investigated. Later in the investigative process, or when the data are ambiguous or in conflict, original trading records are requested.

By the end of fiscal 1986, almost all exchanges had some form of computer-assisted trade practice surveillance system in place. For example, both CME and CBT have computerized trade surveillance systems which are intended to identify potential trade practice violations. Both the exchanges' and the Commission's ability to conduct effective trade surveillance, including computer-assisted surveillance, has been enhanced substantially with the implementation of improved audit trail systems under which an execution time to the nearest minute must be obtained for each trade. Such systems were put into effect at all exchanges during 1987 and, for the most part, have been reviewed recently by the Division.

Computerized surveillance programs are most effective in detecting patterns of activity among traders which may be indicative of certain trading abuses such as noncompetitive trading, accommodation trading, or wash trading. Of course, such programs can only detect patterns for the periods of activity to which they are applied. In general, the Commission and the exchanges have operated their systems to conduct reviews on a rotating basis, focusing on selected periods of trading rather than on all trading activity in all contracts. Not only will computerized surveillance disclose only certain types of *potential* trading violations, additional investigation and review of underlying documentation ordinarily will be required to establish whether evidence of such potential violations should be presented to an exchange disciplinary committee or be made the subject of a Commission enforcement action.

The computer-assisted programs generally are less effective in detecting abuses which are susceptible to being effected through alteration of documents, fictitious trade submissions, or other improper activity which may be disclosed only through review and analysis of underlying records, account statements, or witness testimony. Examples of this type of activity are misallocation of trades, withholding of orders, and certain types of prearranged trading or trading ahead of customer orders.

The Commission's own system of computerized surveillance, the Exchange Database System ("EDS") was implemented in late 1986. Commission staff uses EDS to perform daily surveillance activities—primarily at the regional offices—through the conduct of trade practice investigations. EDS provides the means to organize trade data relative to every futures transaction. It uses more than 30 programs designed by CFTC staff to facilitate the detection of trading violations. Data stored in the system routinely are obtained on a monthly basis from the exchanges' trade register tapes, which are required to be maintained by the exchanges under Commission Regulation 1.35(e) and, of course, may be obtained at any other time on an as needed basis.

The EDS programs are designed to detect patterns of trading that might suggest certain trade practice violations—trading ahead of customer orders, disclosure of orders, taking the other side of customer orders, wash trading, accommodation trading, bucketing, and certain types of prearranged trading.

As the Commission has recommended to the exchanges, the Commission continuously has reevaluated and modified its program as it has gained experience with the system and as specific situations have required. The ongoing Justice Department investigation of activity at the Chicago Mercantile Exchange ("CME") and Chicago Board of Trade ("CBT") may necessitate that both the Commission and the exchanges reevaluate their systems of surveillance and may reveal additional areas requiring attention. As such information becomes available, the Commission will reassess the effectiveness of its program in those areas and implement further appropriate changes.

In addition to computerized surveillance, exchange and Commission staff conduct floor surveillance on a random basis. Because of the number of traders on the floor, floor surveillance is more effective in deterring than detecting violative trading practices. Floor presence of regulatory and self-regulatory personnel also provides staff with an opportunity to keep apprised of routine and variant trading practices and procedures, how particular traders trade, and otherwise to gain knowledge of floor rumors and other information from exchange members and exchange or firm personnel.

Apart from whether surveillance programs are designed to detect potential trading abuses, their ability to accomplish that purpose can be evaluated by examining the results obtained. With respect to the Commission's program, when activity is identified through Division trade practice surveillance several types of responses may result. In those instances where suspicious trading activity is detected, that activity is regularly referred to the relevant exchange for further investigation. In some cases, activity may be referred to the Commission's Division of Enforcement.

The Division of Trading and Markets conducted 14 trade practice investigations of activity at the CBT during 1986, 24 during 1987, and 10 during 1988; and conducted 10, 22, and 20 trade practice investigations at the CME for the same respective time periods. As a result of these activities, the Division referred 27 matters to the CBT and CME for further investigation—six to the CME in 1986, two in 1987, and two in 1988; and eight to the CBT in 1986, five in 1987, and four in 1988. These matters involved 48 traders and 23 firms in the aggregate. From 1986 to 1988, the Division also referred six customer complaints it received to the CBT and CME.

Division staff also referred four matters concerning trading at the CBT or CME to the Division of Enforcement during 1986, six during 1987, and three during 1988. These referrals involved 44 traders and 7 firms in the aggregate.

In assessing the effectiveness of an exchange's program, the Division considers both the number and quality of investigations undertaken. In particular, does the exchange's routine affirmative surveillance result in the detection of activity warranting the initiation of investigations of a variety of substantive trade practice abuses; do the files on those and other investigations (e.g., customer complaints) demonstrate that exchange staff thoroughly examined all trading activity and individuals or firms potentially relevant to the inquiry; and does the Division's own review of exchange files support the exchange's conclusions or reveal additional potential abuses which were not investigated or additional investigative actions which should have been undertaken by the exchange?

Although it is difficult to assess the effectiveness of these programs in detecting abuses because there is no means of determining the extent to which abuses may have occurred which escaped detection, or which did not occur because of the deterrent effect of Commission and exchange surveillance systems, it is possible to examine the activities undertaken by the exchanges and to quantify the results of that activity. In this regard, the Commission has ascertained that the CBT, CME, and NYMEX, the three largest futures exchanges, initiated the following numbers of trade practice investigations from 1986 through 1988: [1]

	1986	1987	1988
CBT	27	15	26
Internal	4	2	10
External	23	13	16
CME	151	146	128
Internal	70	38	29
External	81	108	99
NYMEX	134	92	130
Internal	93	62	87
External	41	30	43

In addition to consideration of the numbers and types of investigations conducted by exchanges, the Division's rule enforcement review process has resulted in continuing, significant improvements in exchanges' enforcement programs. The Division's recommendations have addressed such areas as the automation of surveillance and enhancements to existing computer systems (described in detail above), improved recordkeeping, increased surveillance of particular types of conduct, greater coverage of exchange activities, increased attention to high volume contracts, more thorough investigation of potentially violative activity, stricter enforcement through imposition of sanctions, application of sanctions to all persons implicated in the violative trading identified, and more aggressive deterrence of recidivism.

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[1] For purposes of this chart, internal and external refer to whether the source of the investigation was exchange data or staff expertise or information received by the exchange from third party sources, such as complaints.

For the most part, exchanges have responded affirmatively to the Division's recommendations. For example, there generally has been a marked increase in the levels of sanctions imposed on members found to have violated exchange rules. Similarly, there generally have been substantial increases in the resources and personnel dedicated to exchange compliance activity.

The Commission continually reevaluates its surveillance systems. Similarly, under the Commission's regulations effective self-regulation involves the assessment and upgrading of exchange surveillance programs to cover new products and market situations. Moreover, those programs are supplemented by enforcement, including criminal enforcement activities.

Q.2. Have exchange audit trail systems required under CFTC rule 1.35 been implemented adequately?

A.2. An audit trail is the paper trail for each trade. Generally, audit trail data include such items as customer order tickets, broker trading cards, and time and sales reports, which indicate price changes to the nearest 10 seconds. The amendments to Commission Regulation 1.35 requiring that a time of execution to the nearest minute be obtained for each trade, which replaced the less useful requirement of half-hour time brackets, were published in the *Federal Register* on January 14, 1986. During 1987, all futures exchanges had implemented audit trail systems which are intended to meet that standard.

To date, the Division has completed its initial rule enforcement reviews of the audit trail systems of the New York Mercantile Exchange ("NYMEX"), Kansas City Board of Trade ("KCBT"), Commodity Exchange, Inc. ("COMEX"), Minneapolis Grain Exchange ("MGE"), Chicago Mercantile Exchange ("CME"), New York Cotton Exchange ("NYCE"), and Chicago Board of Trade ("CBT") (including its affiliate exchanges, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange). The Division found that each of these exchanges generally has developed an adequate audit trail system initially to meet the one-minute performance standard established by Commission Regulation 1.35. In addition, the Division is currently in the process of reviewing the audit trail systems of the New York Futures Exchange ("NYFE") and Coffee, Sugar & Cocoa Exchange ("CSC").[2]

Audit trail systems fall into three general categories: computerized, hand-recordation systems and exchange-timed. Computerized systems impute trade execution times through iterative processes, taking data from a number of sources (such as trading cards and order tickets) and deriving times through the comparison of this information. Hand-recordation systems simply require traders to record the one-minute execution time for each trade on a trading card and to submit these data to the exchange. Systems in which trades are exchange-timed provide for the mechanical timestamping of trades automatically or by an exchange employee. The CME, CBT, and CSC employ computerized audit trail systems. The remaining exchanges either require their members to hand-record audit trail times or employ a system in which every trade is timestamped to the nearest minute (NYMEX, PBT, ACC).

In its public reports on these systems, the Division has recommended various enhancements. With regard to computerized audit trail systems at the CBT and CME, the Division recommended that the exchanges develop methods to reduce errors in the data from which trade execution times are imputed. Among other things, the exchanges were urged to take steps to improve compliance with exchange requirements for the reporting of times for trades executed for other members who are on the floor of the exchange (so-called Customer Type Indicator 3 trades) and for spread transactions. The reports also recommended more frequent collection of trading cards and other measures to reduce the prospect that timing and other data could be altered or inserted after the fact. The Division also emphasized the need for maintaining a high level of verifiable execution times and urged improvements in the times obtained for local-to-local trades. At CBT, the Division also recommended improvements in the manner in which the system logic is applied to obtain imputed times.

With regard to hand-recordation audit trail systems, the Division's recommendations have focused on the enhancement of methods for verifying trade execution times and on methodologies for continued improvement in timing accuracy. The accuracy of hand-recorded times, for example, can be assessed by comparing them to the time and price data gathered daily by an exchange and compiled in its time and sales reports and through comparisons to the time submitted by the member on the opposite side of the trade. The Division recommended generally that exchanges make more effective use of such data comparisons on a regular basis to assess the accuracy of times being submitted. Finally, in every case, the Division recommended exchange vigilance in identifying and sanctioning member noncompliance.

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[2] The Philadelphia Board of Trade ("PBT") and Amex Commodities Corporation ("ACC") have access to their parent securities exchanges' audit trail systems and have minimal trading volume and, thus, are not scheduled to be reviewed in the near future.

The exchanges, in the course of implementing their systems, have also made changes and refinements in addition to those recommended by the Division, such as improvements in their matching and clearing systems. Further, they have integrated the use of audit trail data into their ongoing trade practice surveillance programs. Although the Division believes that there should be improvement in exchange audit trails, the Division generally is satisfied with the overall initial implementation of the programs by the exchanges.

Q.3. How effectively are disciplinary programs aimed at deterring trading abuses being administered?

A.3. Maintenance of an effective program for disciplining members who have committed trading violations, often at the expense of their customers, is an essential part of the exchanges' broad self-regulatory responsibility to preserve the integrity of the marketplace and to protect the public interest. Guideline No. 2 (May 13, 1975) (CCH Comm. Fut. L. Rep. ¶ 6430) and Commission Regulation 1.51 require that exchanges have in place procedures to take prompt, effective disciplinary actions against members for rule violations. In the rule enforcement reviews conducted from 1986 through 1988, the Division generally determined that the exchanges are fulfilling their self-regulatory responsibility with respect to the administration of effective disciplinary programs. In most instances, the Division found that the exchanges imposed a number of significant sanctions that were reasonably calculated to deter future trading abuses.[3]

In analyzing the various exchange disciplinary programs, the Division examines the following: (1) timeliness of the disciplinary process; (2) whether decisions were supported by the evidence; (3) the adequacy of the sanction, including the considerations in levying sanctions, *e.g.*, the nature of the violation (technical or substantive), the deterrent effect of the sanction, nature of damages or injury, and whether the same member repeatedly has committed the same or similar trade practice abuses.

The disciplinary programs of the various futures exchanges are administered in accordance with respective exchange rules which have been adopted and implemented in compliance with Part 8 of the Commission's regulations. Part 8 sets forth the standards which an exchange must follow in establishing, *inter alia*, procedures for adjudicating possible rule violations. Generally, the standards contained in Part 8 are designed to ensure that exchange disciplinary proceedings are conducted with procedural due process in a thorough, impartial and expedient manner. If it is alleged or appears that the disciplinary proceeding was not conducted in accordance with Part 8, the Commission may review the disciplinary action under Part 9 of its regulations.

Statistics compiled by the Division from disciplinary notices filed by the exchanges, which provide an overview of the disciplinary actions taken by all exchanges from 1986 to 1988, indicate that monetary sanctions imposed by all exchanges for trade practice violations totaled approximately $1,261,700 in 1986, $2,712,625 in 1987, and $1,751,672 in 1988.[4] These fines are in addition to those levied for other types of violations, such as those involving market surveillance or financial requirements. Further, exchanges have sanctioned trade practice violations with suspensions from several days to several years, and expulsions. From 1986 to 1988, the various exchanges suspended 123 members and expelled 20 members.

The Division notes that in 1987 and 1988, exchanges in New York and Chicago imposed sanctions for trade practice, financial, and market surveillance violations on 675 individual members and member firms, of which the Division would characterize 207 members (31 percent) as major market participants, based upon either extensive trading activity, positions on exchange committees, or other positions which might permit them to influence disciplinary decisions.

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[3] The Minneapolis Grain Exchange ("MGE") was an exception. In its 1988 rule enforcement review, the Division found that MGE had conducted no investigations of trade practice violations and, thus, had taken no disciplinary actions in this regard. As a result, an administrative proceeding was brought against that Exchange by the Commission's Division of Enforcement. That proceeding was settled, and, among other things, a civil penalty of $30,000 was assessed.

[4] Data by exchange can be found attached as Appendix A.

1.2. Data on the number of complaints received by the CFTC from market users regarding alleged mishandling of orders on exchange floors.

A.2. Mishandled orders [5] may be characterized in the context of complaints Commission staff receives regarding trade practice abuses or errors occurring on the floor of exchanges, to include:

—Order was to buy, but contract was sold, and vice versa;
—Order was not executed, customer not informed;
—Order was to trade one commodity, but another was traded, for example, gold rather than silver;
—Individual on the floor did not follow instructions, that is, trade executed at market instead of limit price, etc.

The CFTC received 24 such complaints during 1988.[6] In addition, a separate category of complaints received by Commission staff pertains to trading fraud, which includes:

—Any type of fraudulent activity occurring off the floor that relates to trading in a customer's account, e.g., churning, unauthorized trading, misappropriation, illegal trade allocation, bucketing, etc.

The CFTC received 462 such complaints during 1988.[7]

1.3. Data on the size and budget of the CFTC enforcement staff and the portion of that staff assigned to trade practice-related matters for each year beginning 1980.

A.3. The budget and full-time equivalent ("FTE") staff levels, including clerical support staff, for the Commission's Division of Enforcement are set forth in the following table.

Fiscal year	Dollars (in thousands)	Staff level
1980	$4,295	106
1981	4,406	106
1982	5,104	110
1983	5,252	114
1984	5,545	109
1985	6,717	125
1986	6,621	118
1987	7,362	125
1988	8,203	136
1989	9,118	144

Enforcement attorneys and investigators typically are assigned to a number of different cases and investigations at any given time. These can involve subject areas that include trade practice, fraud by registrants (including futures commission merchants, commodity pool operators, commodity trading advisors, or introducing brokers), manipulation, the sale of illegal off-exchange instruments, failure to file required reports or maintain required records, and failure to register when required, among others.

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[5] Many of the customer complaints received and reviewed by the Commission's staff do not describe readily identifiable wrongdoing by a broker or futures commission merchant. However, when customer complaints do allege readily identifiable wrongdoing, they often allege more than one violation. Consequently, for purposes of this compilation, if a complaint contains any allegation that falls within either of the categories stated in this response, it is included in the total.

[6] Many customer complaints alleging instances where a customer believes that he or she did not receive the best price available on the exchange floor at the time an order was executed, are susceptible to negotiated resolution by the broker and customer. In such cases, the Commission may receive no notice that a customer was dissatisfied. As a result of these and other factors, the Commission receives a relatively low number of complaints that specifically relate to mishandling of orders on the floor.

[7] Neither category includes complaints which relate to solicitation fraud. This type of complaint involves any fraudulent activity associated with the solicitation of customer accounts, e.g., claims of certain profit, not disclosing the risk of financial loss, exaggerated or false claims of experience and background, etc.

During each of the last 5 fiscal years (for which records are more readily available), the trade practice category has been among the top two or three concentrations of enforcement staff time. Variations in the concentration of staff time can result from a variety of factors, including litigation schedules and the occasional need to divert staff to address extraordinary market events. The percentage of total enforcement litigation and investigation time spent on trade practice matters for fiscal years 1985 through 1989 (through the first quarter) was:

Fiscal year	Percentage of time
1985	14.4
1986	19.8
1987	11.6
1988	16.3
1989 (first quarter)	13.3

During this period overall, fraud by futures commission merchants was the only subject area that consumed a higher percentage of enforcement litigation and investigative time than trade practice.

In addition to Commission enforcement activities, those aspects of trade practice oversight conducted by the Division of Trading and Markets are carried out by the Contract Markets Section, which is responsible for direct oversight of exchange compliance programs and for direct trade practice surveillance to assess the quality of those programs. Direct surveillance generally is conducted by staff in the regional offices. The following table reflects the budget and FTE staffing of the Contract Markets Section, including certain legal and support staff, for fiscal years 1980 to 1987. For fiscal years 1985 to 1988, separate figures show staff years dedicated to the oversight and surveillance duties of the office and show actual positions dedicated to direct surveillance in the regional offices.

DIVISION OF TRADING AND MARKETS—CONTRACT MARKETS BUDGET AND STAFF—FISCAL YEARS 1980–1988

	Fiscal year 1980	Fiscal year 1981	Fiscal year 1982	Fiscal year 1983	Fiscal year 1984	Fiscal year 1985	Fiscal year 1986	Fiscal year 1987	Fiscal year 1988
Funded FTE	18.8	31.8	30.9	31	34	34	33	[a] 37	32
Amount (000)	$706	$1,269	$1,357	$1,408	$1,640	$1,650	$1,734	$2,060	$1,878
Dedicated [b] FTE	N/A	N/A	N/A	N/A	N/A	27	26	30	30
Regional	N/A	N/A	N/A	N/A	N/A	10	12	12	14

[a] These figures are for total funded full-time staff years, not the actual number of staff positions, and include staff years for the Contract Markets Section, as well as staff years allocated to the Director's office and legal counsel from 1980–1987. For the period 1980–1987, commensurate with the increase in FTE's, approximately 3 staff years to seven staff years were attributable to the Director's office and legal support. For FY 1988, the reduction of five FTE's is due to the allocation of those FTE's to the formal establishment of a subprogram with respect to regulatory development activities which represents those positions formerly allocated to legal support. Also for 1988, two FTE's were allocated to the Director's office.

[b] These figures are staff years dedicated to oversight and surveillance activities.

I.4. Data on the size and budget of the compliance staff of each designated exchange for each year beginning 1980.

A.4. The Division collects data concerning exchange budgets and staff on a biennial basis as indicated below. Figures for 1980 through 1986 are actual expenditures. However, the 1988 figures were furnished prior to the Exchange's closing out their books for 1988 and as a result the figures are projected expenses. In addition, Amex Commodities Corporation, Chicago Rice and Cotton Exchange, MidAmerica Commodity Exchange, and the Philadelphia Board of Trade's respective parents, the American and Philadelphia Stock Exchange, provide audit and compliance services, but do not distinguish them for budgetary purposes from those supplied for the stock exchanges. Likewise, the Chicago Board of Trade provides audit and compliance services for the MidAmerica Commodity Exchange and Chicago Rice and Cotton Exchange.

Figures generally, include staff who have direct duties in the Compliance Department, *e.g.*, trade practice, audit trail, financial audits, market surveillance, and legal and computer staff.

	1980	1982	1984	1986	1988
Chicago Board of Trade:					
Compliance budget	$1,016,000	$1,337,000	$2,004,000	$2,657,000	$3,553,000
Compliance staff	44	48	70	78	83
Chicago Mercantile Exchange:					
Compliance budget	$2,036,000	$3,008,000	$3,785,000	$5,925,000	[10] $3,931,000
Compliance staff	32	37	40	60	89
Coffee, Sugar and Cocoa Exchange:					
Compliance budget	$411,535	$661,385	$616,500	$676,000	$852,000
Compliance staff	19	19	17	17	23
Commodity Exchange, Inc.:					
Compliance budget	$622,000	$890,000	$1,155,000	$1,527,135	$1,015,000
Compliance staff	24	34	39	[11] 29	33
Kansas City Board of Trade:					
Compliance budget	$90,000	$145,000	$175,000	$368,000	$252,600
Compliance staff	4	6	7	7	5
Minneapolis Grain Exchange:					
Compliance budget	$76,800	$105,000	$118,230	$167,350	$312,000
Compliance staff	2	2	2.5	3	8
New York Cotton Exchange:					
Compliance budget	$444,087	$550,155	$504,394	$869,000	$1,400,000
Compliance staff	10	11	10	17	15
New York Futures Exchange:					
Compliance budget	[12] $3,395,000	[13] $2,156,000	[14] $400,000	$1,100,000	$1,050,000
Compliance staff	22	16	6	7	11
New York Mercantile Exchange:					
Compliance budget	N/A	$710,690	$812,500	$819,359	$2,345,000
Compliance staff	11	15	20	18	33

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[10] The 1988 CME budget figure has been adjusted downward to eliminate overhead and data processing expenses. This was done to make that figure consistent with the manner in which other exchanges' budgetary figures were computed. Notably, however, the figures for the CME for prior years have not been adjusted similarly.

All of the data reflected on the above chart had been collected by Commission staff for internal Commission purposes rather than for the comparison of exchanges. Accordingly, the exchange's methodology for generating these data varied. In the future, Commission staff intends to direct the exchanges to produce these data pursuant to uniform guidelines established by the Commission.

[11] Staff was reduced due to the significant reduction in volume.

[12] Figure includes start-up expenditures and NYSE staff detailed to Exchange.

[13] Figure includes market surveillance and clearing firm activities.

[14] Figure is strictly salaries and benefits.

I.5. An analysis of current Exchange rules regarding dual trading, trading ahead of customers, prearranged trading, oral orders, and other rules designed to prevent mishandling of customer orders by floor brokers.

A.5. Sections 4b and 4c of the Commodity Exchange Act ("Act") delineate and directly address prohibited trading practices. The Act also prohibits other trading related abuses, such as fraud and manipulation. The Act requires that an exchange have provisions to make effective the requirements of the Act in order to be designated as a contract market, and that the exchange enforce all rules. Domestic futures exchanges, through their compliance efforts, maintain trade practice surveillance programs that monitor for these trading abuses. In addition, Commission Regulation 155.2 requires exchanges to promulgate rules which establish trading standards for floor brokers and prohibit such trading abuses as (1) trading ahead of customers, (2) trading against a customer's order, (3) prearrangement, and (4) other types of noncompetitive trading.

The definitions of the trade practice violations furnished below are solely for informational purposes. All domestic exchanges address each of these trade practice violations. The actual articulation of the stated violative practices in the exchanges' disciplinary proceedings may vary on a case-by-case basis. Similarly, the legal standards applicable to prohibitions in the Act and the Commission's Regulations are set forth in Commission administrative decisions and other case law.

1. *Trading ahead of customers.*—Trading ahead occurs when a floor broker executes a trade for his personal account, or an account in which he has an interest, while having in hand any executable customer order in the commodity. A trading ahead violation can occur in any futures or option contract in the same commodity

as the customer's order, even if the floor broker's trade is in a different contract month.

2. *Disclosure of orders.*—Exchanges prohibit floor brokers from disclosing the contents of orders of another person and/or divulging any order revealed to them by reason of their relation to the party placing such order, except as necessary to pass off a discretionary order or as requested by the Commission or an exchange official.

3. *Improper allocation of trades.*—Floor brokers are prohibited on all exchanges from unfairly allocating trades among accounts. Orders must be executed and allocated in the order in which they are received in the pit.

4. *Withholding orders.*—Floor brokers are prohibited from withholding or withdrawing orders from the market for the benefit or convenience of another member. The purpose of this restriction is to prevent floor brokers from acting against the best interest of their customers for the benefit of other floor brokers or traders.

5. *Taking the other side of a customer order.*—A member of an exchange is prohibited from willfully and knowingly taking the opposite side of an order of a customer without his prior consent. Commission regulations require exchanges to adopt rules prohibiting such trades, commonly known as cross trades, unless they are executed in conformity with exchange rules approved by the Commission. While some exchanges prohibit this trading activity, most exchanges allow floor brokers to take the opposite side of a customer order with that customer's prior consent.

Similar rules have been promulgated by most exchanges to govern when a floor broker crosses two customer orders. In this regard, a floor broker may execute simultaneous buy and sell orders from different principals for the same contract and month provided that the transaction is executed in accordance with Commission regulations. Commission Regulation 1.39 provides that these transactions may be executed by crossing provided that the orders are first offered openly and competitively by open outcry on the trading floor, are crossed in the presence of an exchange official, are clearly identified on the floor broker's trading card as a cross trade, and that the card is promptly presented to an exchange official for initialing. Trades executed pursuant to such regulations and approved contract market rules are deemed not to constitute prohibited cross trades under Section 4b(A) of the Act.

6. *Wash trading.*—Wash trading can be described as entering into or purporting to enter into transactions giving the appearance that purchases and sales are being or have been made without actually taking a *bona fide* position or incurring market risk.

7. *Accommodation trading.*—Accommodation trading can be described as trading entered into by one broker to assist another broker in accomplishing trading objectives through unlawful means.

8. *Fictitious sales.*—A fictitious sale involves the use of trading techniques that give the appearance of submitting trades to the open market while negating the risk or price competition incident to such market.

9. *Bucketing.*—Bucketing can be described as any failure to introduce an order into the marketplace. All exchanges require all orders to be introduced into the marketplace and competitively executed. A bucketed trade does not receive a competitive execution and is often not offered by open outcry in violation of Commission Regulation 1.38, which requires competitive execution of all trades.

10. *Prearranged trading.*—A prearranged trade generally is understood to mean any transaction where any aspect of a trade has been agreed to in a manner that eliminates or significantly reduces price competition or market risk in violation of Commission Regulation 1.38.

1.6. Copies of all current CFTC or Exchange rules applicable to floor broker associations or groups. Please also provide copies of any CFTC studies or analyses concerning these associations or groups.

A.6. Although there is no provision of the Act or Commission regulation which directly addresses broker associations or groups, all regulations promulgated concerning floor trading, including the trading standards for floor brokers delineated in Commission Regulation 155.2, apply to broker associations or groups.

The Chicago Mercantile Exchange ("CME") is currently the only exchange that has promulgated a rule directly addressing broker associations. CME Rule 515, attached, which was amended in November 1987 and February 1988 to address certain problems in the S&P 500 pit, sets forth definitions as well as registration and financial requirements of broker associations. The rule also sets forth broker associations' limits on personal and customer trading.

In addition, Commodity Exchange Inc. ("Comex") and New York Mercantile Exchange ("NYMEX") rules address the related issue of trading between affiliated brokers. Comex Rule 4.24(a) and NYMEX Rule 6.42(c), attached, establish that if two partners of the same partnership, two employees of an employer, or an employer and his employee execute buy and sell orders from different customers opposite each other, they must execute those orders in accordance with each respective Exchange's cross trade rules.

The Commission has not conducted any studies or analyses concerning broker associations or groups. Nor has the Commission conducted studies concerning the sharing of decks among brokers. The Commission staff, however, has nearly completed a survey of each exchange concerning its rules and procedures with regard to split Commission arrangements.

[CME Rule 515 and COMEX Rule 4.24(a) and NYMEX Rule 6.42(c) follow:]

CME Rule 515

515. REGISTRATION OF BROKER ASSOCIATIONS

A. DEFINITIONS

1. Broker Association--A broker association shall include the following associations, groups and entities:

a. Employer Employee Association: An employer and each employee-broker: for example, a clearing member and its salaried or commissioned brokers: a floor broker and his employee-brokers.

b. Partnership, Limited Partnership, Joint Venture, etc., Associations: for example, two or more brokers who share and or allocate brokerage fees, revenues, expenses, profits, or losses.

c. Affiliated Broker Associations: Brokers who regularly share a deck (customer orders) and or employee salary expenses: for example, a floor broker and a local broker who holds the deck on a regular, though limited, basis; or two or more floor brokers sharing an employee.

d. A trading group shall be deemed a member of each broker association to which a member of that trading group belongs.

e. Any other group or combination deemed by the Board of Governors to be a broker association.

2. Principal of a Broker Association—Each individual who has formal and or de facto control over the affairs of the association. Each principal must be an equity member of the Exchange.

3. Associate of a Broker Association—Any member of a broker association unless that individual is a principal of the broker association. Each associate of a broker association must be a member of the Exchange.

4. Trading Group—An association of two or more Exchange members sharing directly or indirectly, revenue resulting from trading either the group's account or their own individual accounts.

B. REGISTRATION REQUIREMENTS

1. A floor broker who is a member of a broker association shall not execute a trade on behalf of a customer(s) unless that association has registered with the Exchange.

2. Information Required—Registration shall be accomplished by filing a registration form with the Membership Department which shall include the following information, except that a clearing member shall register by submitting a list of all floor broker employees executing orders for that clearing member:

a. Name of broker association;

b. Names and account numbers of all principals, associates, investors, partners, and shareholders of the association;

c. Identification, by account number, of each trading group in which a principal or associate of the broker association has a financial interest;

d. Legal form of association;

e. Category registered under pursuant to subsection A.1. above.

f. Principal authorized to represent the association.

3. Requirement of Keeping Registration Current—It shall be the responsibility of the broker association and its principals to insure that the association is properly registered. Any additions, deletions, or other changes to the information already reported must be provided to the Membership Department within two business days after the event giving rise to such changes.

4. The Exchange may request any additional data from a broker association as deemed appropriate.

C. SUPERVISION

Each principal must supervise his associates and employees diligently to prevent unsound business practices and uphold all Exchange rules.

Any principal of a broker association defined by subsections A.1.a., or A.1.b., who directly or indirectly controls any person who has violated any rule of the Exchange in connection with his duties or responsibilities to the association may be held liable for such violation to the same extent as such controlled person. Regardless of whether the principal was held responsible for the act or acts constituting the violation, each principal of any broker association is jointly liable for the payment of any fines assessed against another principal, associate or employee of his association provided the violation occurred while that person was acting or performing his duties on behalf of the association.

D. FINANCIAL RESPONSIBILITY

Each principal of a broker association defined by subsections A.1.a., or A.1.b., jointly agrees to guarantee and assume complete financial responsibility for all trades executed by members of his association including errors, out-trades or omissions in connection with that members duties or responsibilities to the association.

E. INTRA-ASSOCIATION TRADING

The Board shall establish limits on the percentage of personal trading between a member of a broker association and other members of broker associations with which he is affiliated.

The Board shall establish limits on the percentage of customer orders (defined as CTI type 2, 3 and 4 trades) that a member of a broker association may fill opposite other members of broker associations with which he is affiliated.

The limits established by the Board shall take account of liquidity and such other conditions, from contract to contract, and shall only apply to the most active month or months of any contract. Compliance shall be measured separately for each full calendar month. Different broker associations operating in the same pit which have one or more principals in common shall be deemed a single association for the purpose of this subsection.

F. VIOLATION OF THIS RULE

Violation of this rule may be a major rule violation. Repeated violations of this rule by members of a broker association may result in revocation of the principals' right to act as floor brokers.

COMEX Rule

4.24 *Crossing of Orders.*

(a) *Crossing of Orders Defined.* Orders shall be deemed to have been crossed when a single floor member simultaneously executes matching buy and sell orders for two different customers. For purposes of this Rule any two persons having the following relationship at the time they effect a trade between them, shall be deemed to be effecting a cross trade subject to all the provisions of this Rule:

(1) partners;

(2) employees of the same employer;

(3) an employer and his employee; and

(4) any two members when one of them is temporarily acting in a capacity described in (1), (2) or (3) above, if and only if such two members have knowledge of the same.

(b) *Permissible Cross Trades.* If a floor member receives buying and selling orders at prices which permit their execution by the crossing thereof, such floor member may act as buying and selling broker in the execution of such orders upon compliance with the following conditions:

(1) he shall offer the futures contract or futures option series openly and competitively by public outcry at the ring by both bidding and offering for a stated volume; (i) for all transactions other than straddles, to a point where such offer is higher than such bid by not more than the minimum permissible price fluctuation applicable to such futures contract or futures option series; and (ii) for straddles by bidding and offering at the same point spread or differential;

(2) neither such bid nor such offer is accepted; and

(3) he announces to the ring and to an employee of the Exchange the execution of such cross trade and the quantity and price thereof.

(c) *Floor Members' Records for Cross Trades.* A floor member executing a cross trade immediately after execution shall clearly identify the same on an order ticket or other record in form approved by the Exchange, noting thereon the exact time of execution, the date, the price, the quantity, the futures contract or futures option, the delivery month or futures option series, the customer's account numbers, and the clearing member which will clear each side of the trade.

(d) *Exchange Records for Cross Trades.* It shall be the obligation of a floor member executing a cross trade to ensure that every cross trade executed in the ring shall be promptly made a matter of permanent record of the Exchange by the official market reporter which record shall include the exact time of execution, the date, the price, the quantity, the futures contract or futures option, the delivery month or futures option series and the name of the floor member executing the cross trade.

NYMEX Rule

¶ 3612

Rule 6.42. PROCEDURES—SIMULTANEOUS BUY AND SELL ORDERS

(A) Trading Members who have for execution orders from different principals for a commodity in the same delivery month or for the same option (both puts or both calls, with the same underlying contract for future delivery, expiration date, and strike prices may act as both buying and selling broker in the execution of such orders. Such Trading Members shall execute all transactions executed under Rule 6.40 in the presence of a designated Exchange employee or a member of the Floor Committee, who shall initial the trading member's card after the execution of the cross-trade only if the Trading Member has followed the procedures set forth in Rule 6.40 and in this Rule 6.42.

[Rule 6.42(A) amended effective September 16, 1986.]

(B) After the Trading Member has offered and bid, as required by Rule 6.40, the Trading Member must satisfy all proper bids and offers in the ring before crossing the orders.

(C) For the purposes of Rule 6.40 and 6.41(E), any two Trading Members who have the following relationships at the time of a trade between them are affecting a cross-trade, such trade must be executed in compliance with these rules and procedures:

(i) employer and employee;

(ii) employees of the same employer;

(iii) partners of a partnership; and,

(iv) officers, directors and ten percent (10%) shareholders of the same corporation.

¶ 3615

Rule 6.43. FLOOR BROKER REGISTRATION REQUIREMENTS

(A) No trading member shall act as a Floor Broker unless such person is registered with the Commission as a Floor Broker in accordance with the provisions of the Commodity Exchange Act and the provisions of any Regulations thereunder promulgated by the Commission.

(B) Each member registered as a Floor Broker shall furnish to the Exchange a copy of the Form 8-R and any supplements thereto filed in connection with such registration. The Floor Broker shall inform the Exchange and the National Futures Association within thirty (30) days of any material change in information stated on the Form 8-R or supplement thereto.

[Rule 6.43(B) added effective September 29, 1986.]

¶ 3618—3623 [Reserved]

Rules 6.44—6.49. [Reserved]

¶ 3626

Rule 6.50. SETTLEMENT PRICES

The settlement price for each commodity futures contract shall be determined by the Settlement Price Committee using the procedures set forth in Rule §§ 6.52 through 6.54, and for each commodity options contract using the procedures set forth in Rule § 6.55.

[Rule 6.50 amended effective September 16, 1986.]

[The next page is 3523-3.]

I.7. A description of how the CFTC currently monitors activities on exchange trading floors. Please describe the presence which CFTC staff normally maintains on the exchange floors, including the numbers of staff regularly assigned to each exchange floor and the nature of their floor-related responsibilities.

A.7. Division of Trading and Markets staff uses floor surveillance for a variety of purposes. During the course of routine trade practice investigations, conducted primarily through the use of computer analysis of trade data and examination of trading documents in the office, observation of trading floor activity may be necessary to understand more fully how trading is conducted in a particular pit. For example, the physical location of certain traders may help to explain the amount of trading between them or perhaps raise questions as to the accuracy of the trading documents reflecting such activity. Division staff also routinely observes certain market events such as the initiation of trading in new futures and option contracts and the expiration of certain contracts to determine whether trading is orderly and the level of trading activity appears to be consistent with market conditions and expectations. Further, during times of market "stress," either actual or anticipated, Division staff endeavors to be present to determine whether the trading is occurring in as orderly a manner as possible under the circumstances and to obtain data which may assist in formulating possible Commission action during such times.

The presence of Division and exchange compliance staff may deter rule violations. However, it is difficult to measure this deterrent effect and the extent to which it might be increased by additional floor presence of either Commission or exchange staff, although the results of the current investigation may provide some data relevant to this issue. On the other hand, the value of floor surveillance for detecting potential trading abuses may be more limited because what is observed may be ambiguous. To the extent floor observations indicate possible trading abuses based on observation rather than informants, such activity generally must be investigated further and substantiated by record review and other investigative techniques.

The presence of Division staff on the floor is at least two to three times a week per exchange in Chicago. This function is performed by six Division staff members. During such times as the October 1987 market break, staff was present virtually continuously.

The Division of Economic Analysis also conducts routine floor surveillance in conjunction with its everyday review of computer reports of large trader activity and is present at the expiration of all futures and most options contracts and at various other times when significant news has occurred or is expected to occur such that increased price volatility is expected. Twelve staff members of the Division of Economic Analysis perform this function in Chicago. In addition, the Commission staff in Chicago from both Divisions conducts scheduled floor surveillance of the Chicago Board of Trade's evening session once each week.

I.8. A listing of all trade practice related enforcement cases including floor broker registration actions—brought by the CFTC since January 1, 1983. For each case, please specify the nature of the violation alleged, the exchange and contract involved, whether the exchange had taken action with respect to the violation, how the violation was discovered, the penalty sought by the Division of Enforcement, and the penalty finally assessed, if any.

A.8. Since January 1983 the Commission has brought trade practice enforcement actions (including statutory disqualification proceedings against floor brokers) against 97 individuals and firms in 38 proceedings. As a result of these actions, the

Commission has assessed over $2,705,000 in civil penalties (a small proportion of which is subject to appeal), has revoked, suspended, or denied the registrations of 38 persons or firms (5 subject to appeal), has revoked or suspended the trading privileges of 49 persons or firms (5 subject to appeal), and has entered 69 cease and desist orders (3 subject to appeal). In certain cases, the Commission also has obtained specific undertakings from respondents to address alleged compliance and supervision deficiencies. The attached table lists the cases, the sections of the Act and Commission regulations allegedly violated, the exchanges and contracts involved, and the civil penalties assessed.[15]

In order to foster the efficient allocation of exchange and Commission resources, the Commission endeavors to avoid duplicating exchange disciplinary activity. Thus, in all subject areas, the Commission is more likely to take enforcement action in those cases where an exchange has failed to detect or act upon an alleged violation, or where the exchange lacks the ability to address fully the wrongdoing, such as where a violation involved non-members who are beyond the exchange's disciplinary authority.[16] Moreover, the Commission's Division of Trading and Markets, which conducts routine trade practice surveillance of the exchanges, often refers potential trade practice violations that it detects to exchange compliance officials for further exchange action.

Where a violation of the Act or Commission regulations is proven in a Commission enforcement action, the Act authorizes the Commission to issue an order directing respondents to cease and desist from further wrongdoing, suspend or revoke registrations with the Commission, prohibit or suspend respondents from trading in any markets regulated by the Commission, and impose civil monetary penalties of up to $100,000 per violation. When assessing a civil penalty, section 6(d) of the Act, 7 U.S.C. § 9a, states that the Commission shall consider several factors about the particular respondent. In the case of a respondent whose primary business involves the use of the futures markets, the Commission shall consider the appropriateness of any civil penalty to the size of that business, the extent of the person's ability to remain in business, and the gravity of the violation. In the case of a respondent whose primary business does not involve the use of the futures markets, the Commission shall consider the appropriateness of the penalty to the net worth of the person charged and the gravity of the violation.

TRADE PRACTICE CASES INSTITUTED JANUARY 1983 TO JANUARY 1989

Case name, No. of respondents, and Docket No.	Section(s) of act alleged	Section(s) of regulations alleged	Exchanges	Exchange [1] action	Contracts	Penalty amounts
Mocatta Metal Corporation, 8, 89-3.	4c(a)(A), 4c(a)(B), 4g.	1.38(a), 1.35(a-1)(1), 1.35(a-1)(2).	COMEX	No	Silver and gold	8 penalties totaling $527,500.
Three Eight Corporation, 6, 88-33.	4c(a)(A)	166.3	CBT	No	MMI and corn	Pending.
Minneapolis Grain Exchange, 1, 88-27.	5a(8)	1.51, 1.53, 8.06.	MGE	No	Wheat, corn syrup	$30,000.
Kidder Peabody & Co., Inc., 5, 88-6.	4c(a)(A), 4b(D), 4c(a)(B), 4g.	1.38(a), 1.35(a-1).	CBT	Yes	MMI	Pending.
Johanning, Jerome B., 4, 87-13.	4b(D), 4c(a)(A), 4c(a)(B).	1.38(a)	MGE	No	Wheat	4 penalties totaling $14,400.

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[15] Also attached is a brief description of the sections of the Act and regulations listed on both this table and the table submitted in response to question 10.

[16] As noted in response to Question 3 and Item 10, the Commission may take enforcement action where an exchange fails to maintain an adequate program to detect and sanction trade practice abuses.

TRADE PRACTICE CASES INSTITUTED JANUARY 1983 TO JANUARY 1989—Continued

Case name, No. of respondents, and Docket No.	Section(s) of act alleged	Section(s) of regulations alleged	Exchanges	Exchange [1] action	Contracts	Penalty amounts
Harlow, 2, 87-8	4b(A), 4b(B), 4b(C), 4b(D), 4o(1).		Not specified in complaint.			$0.
Woodstock, Inc., 5, 87-4.	4b, 4e	1.38(a), 1.35(a-1), 166.3.	CBT	No	T-Bond	2 penalties totaling $315,000 (pending).
Kidder Peabody & Co., Inc., 1, 87-2.	4c(a)(A), 4g(1).	1.35(a), 1.31(a)(1).	CBT	No	T-Bond	$35,000.
Emanuel Capital Administrators, 4, 87-1.	4c(a)(A), 4c(a)(B), 6(b).	1.38	COMEX	Yes	Gold	4 penalties totaling $80,000.
Shatkin Trading Company, 8, 85-46.	4c(a)(A), 4c(a)(B), 4i, 6(b), 4g, 4e.	1.38(a), 18.04(a), 18.04(b), 18.04(d), 1.46(a), 1.33(a)(1), 17.00(a), 1.35(a), 1.37(a), 18.04.	CBT	No	CD's	8 penalties totaling $250,000.
E.D.&F. Man Ltd., 5, 85-44.	4c(a)(A), 4c(a)(B).	1.38	Coffee, sugar and cocoa.	No	Sugar	5 penalties totaling $100,000.
Lincolnwood, 2, 85-8	4c(a)(A), 4c(a)(B), 4g, 4e, 4i, 6b, 4d(2), 4d.	1.38, 1.35, 18.04, 1.20(a), 1.28.	COMEX	No	Gold	$70,000.
COMEX, 1, 85-7	4c(a)(A), 5a(8).	1.53, 1.51, 1.51(b), 8.07.	COMEX	No	Gold	$70,000.
Kansas City Board of Trade, 10, 85-6.	4c(a)(A), 4c(a)(B), 4g(1), 5a(8).	1.38, 1.35(d), 166.3, 1.53, 1.51(a), 8.06(a).	KCBOT	Yes	Value line	9 penalties totaling $120,000.
Del Re, Angelo, 1, 85-4.	4c(a)(A), 4g.	1.38(a), 1.35.	COMEX	Yes	Silver	$100,000.
Gimbel, Stuart N., 4, 84-20.	4b(A), 4b(B), 4b(C), 4c(a)(A), 4e, 4f, 4i, 6(b), 8a(3)(G), 8a(4).	1.38(a), 3.31(b), 18.01(d), 18.04(e), 166.2, 18.01(a), 1.14(b), 18.00.	CME	Yes	Lumber	4 penalties totaling $170,000 (appealed).
Turman, Daniel Clay, 1, 84-15.	4c(a)(A), 4c(a)(B).	1.38	COMEX	Yes	Gold	$50,000.

TRADE PRACTICE CASES INSTITUTED JANUARY 1983 TO JANUARY 1989—Continued

Case name, No. of respondents, and Docket No.	Section(s) of act alleged	Section(s) of regulations alleged	Exchanges	Exchange [1] action	Contracts	Penalty amounts
Laspagnoletta, Ronald, 1, 84-14.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$130,000.
Phillips, James H., 1, 84-13.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$100,000.
Flynn, John J., 1, 84-12.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$150,000.
Friedman, Robert I., 1, 84-11.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$100,000.
Petkoff, Stephen, 1, 84-10.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$1,000.
Knack, Robert L., 1, 84-9.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$50,000.
O'Brien, Francis J., 1, 84-8.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$0.
O'Cone, Philip M., 1, 84-7.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$100,000.
Pearson, Lawrence F., 1, 84-6.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$30,000.
Dickson, Frederick J., 1, 84-5.	4c(a)(A)	1.38	Cotton	Yes	Crude oil, cotton and propane gas.	$20,000.
Gilchrist, Charles E., 8, 83-58.	4c(a)(A), 4c(a)(B).	1.38(a)	CME	No	Gold, Swiss Franc, T-Bill and Eurodollar.	3 penalties totaling $42,500 (appealed).
Rodgers, William C., 2, 83-53.	4c(a)(A), 4i, 4e.	1.38(a), 18.04, 18.00.	MACE	Yes	Gold and silver	$50,000.

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[1] Action by the exchange may have predated or followed the Commission's proceeding and may have focused on fewer transactions and parties than the Commission's proceeding.

REGISTRATION ACTIONS AGAINST FLOOR BROKERS BASED UPON TRADE PRACTICE ABUSES—JANUARY 1983 TO JANUARY 1989

Docket and Name	Exchange	Status
SD89-1—Schillaci	CME	Pending.
SD88-3—Greenberg	CME	Revoked.
SD88-2—Sonnenberg	CME	Revoked.
SD88-1—Castellano	CME	Revoked and appealed.
SD86-4—Comenzo	NYCE	Revoked.
SD86-3—Giarritano	CBT, CME	Revoked.
SD85-6—Willetta	NYCSC	6 mos. suspension.
SD85-7—Lerman	NYCSC	4 mos. suspension.
SD85-8—Goldberg	NYCSC	6 mos. suspension.

In Fiscal Years 1983 and 1984, the Commission brought 42 registration cases against persons acting as floor brokers on the exchanges. Whether or not the grounds upon which the registration action was based included trade practice violations is not readily available.

KEY TO SECTIONS ALLEGED

Section and definition

4b—Provides that the prohibitions set forth in the subsections of 4b apply to futures contracts.

4b(A)—Cheating, defrauding or attempting to cheat or defraud.

4b(B)—Making a false statement or entering false records.

4b(C)—Deceiving or attempt to deceive any person with respect to an order or the execution thereof.

4b(D)—Bucketing or offsetting orders, taking the other side of an order without authorization.

4c(a)(A)—Wash sales, cross trades, accommodation trades or fictitious sales.

4c(a)(B)—Reporting non bona-fide prices.

4d(1)—Failure to register as Futures Commission Merchant (FCM) or Introducing Broker (IB).

4d(2)—Failure of FCM to properly segregate customer funds.

4e—Failure to register as Floor Broker (FB).

4g(1)—Failure of FCM, IB or FB to keep proper records or provide Commission access to books and records.

4i—Exceed position limits.

4o(1)—Prohibits Commodity Trading Advisor and Commodity Pool Operator fraud.

5(f)—Failure of contract market governing board assure compliance with the CEA and Commission orders or decisions.

5a(1)—Failure of contract market to furnish the Commission with copies of bylaws, rules, regulations and resolutions or changes thereto.

5a(2)—Failure of contract market to keep required books and records.

5a(8)—Failure of contract market to enforce its bylaws, rules, regulations and/or resolutions.

5a(9)—Failure to enforce all bylaws, rules, regulations and/or resolutions relating to minimum financial standards and related reporting requirements for member FCM's.

5a(12)—Failure of contract market to seek prior Commission approval of bylaws, rules, regulations and/or resolutions.

6—Failure of contract market to comply with requirements of Section 5.

6(a)—Failure of contract market to enforce its rules, violation of contract market rule by the contract market, an officer, agent or employee thereof.

6(b)—Manipulation.

8a(3)(G)—Commission may refuse to register any person who has made a material false or misleading statement of omitted a material fact from his application.

8a(4)—Commission may suspend, revoke or restrict the registration of any person whose registration could have been refused, and may suspend or revoke registration of any FCM or IB accepting orders from any person whose trading privileges have been denied.

KEY TO REGULATIONS ALLEGED

Regulation

1.12(e)—Failure of self-regulatory organization (SRO) to notify Commission that a member registrant has not complied with section 1.12.

1.14(b)—Failure of FB to correct deficiencies in Form 8-R (repealed).

1.20(a)—Failure to properly segregate and account for customer funds.

1.28—Failure of FCM which has obligated customer funds to include such obligations in segregated accounts at values greater than current market value.

1.31(a)(1)—Failure to keep proper books and records.

1.33(a)(1)—Failure of FCM to provide proper monthly customer statements.

1.35—Failure to keep complete records.

1.35(a–1)(1)—Failure to properly prepare customer orders upstairs.

1.35(a–1)(2–4)—Failure to properly prepare customer orders on the exchange floor.

1.35(d)—Failure to properly prepare trading cards.

1.37(a)—Failure to keep a record of customer information.

1.38(a)—Noncompetitive trading.

1.41—Failure to follow procedures for the submission of proposed contract market rules for Commission approval.

1.46(a)—Failure to offset long and short positions.

1.50—Failure of contract market to provide written reports regarding compliance with CEA and Regulations.

1.51—Failure of contract market to use due diligence in maintaining an enforcement program.

1.52—Failure of SRO to adopt or submit to the Commission rules prescribing minimum financial and related reporting requirements for member FCM's.

1.53—Failure of contract market to enforce its bylaws, rules, regulations and/or resolutions.

3.31(b)—Failure of registrant to correct deficiencies or inaccuracies in the Form 8-R.

8.05—Failure of contract market to establish an enforcement staff or to enforce the rules within its jurisdiction.

8.06(a)—Failure of contract market to conduct proper investigations.

8.07—Failure of contract market enforcement staff to properly complete reports of investigations.

18.00—Failure to report reportable positions upon a special call.

18.01(a)—Failure to include all accounts in which trader has financial interest when determining whether to report a reportable position.

18.01(d)—Failure to report controlled accounts (repealed).

18.04—Failure to report reportable position (Form 40).

18.04(a)-(e)—Failure to furnish specified information on the Form 40, failure to update Form 40.

166.2—Unauthorized trading.

166.3—Failure to supervise.

I.9. To the extent appropriate, a listing of all criminal investigations either referred by the CFTC to federal or state authorities or in which the CFTC participated with federal or state authorities since January 1, 1983. For each case, specify the nature of the violation alleged, the role of the CFTC in the criminal investigation and any resulting prosecution, and the outcome of the case.

A.9. The Commission has actively encouraged and participated in cooperative criminal enforcement with federal and state agencies in a number of ways.

REQUESTS FOR ACCESS TO DIVISION FILES

Between October 1, 1985 and February 1, 1989, the Commission's Division of Enforcement ("Division") responded to 85 requests for access to Division files from the Department of Justice, the Federal Bureau of Investigation, the Internal Revenue Service, and the Postal Inspection Service. Such requests for access are the method by which other law enforcement agencies can obtain information gathered by the Commission as part of its law enforcement activity.

ASSISTANCE IN FEDERAL INVESTIGATIONS AND PROSECUTIONS

During the same time period, the Division provided assistance in the investigation or prosecution of 34 federal criminal cases which resulted in the indictment of 113 defendants and 75 convictions. In six of the cases, prosecution continues. A table listing the cases and the results to date is attached. In addition, the Division of Enforcement assisted in 43 other federal criminal investigations which either are ongoing or were closed without institution of charges. Additionally, the Division assisted in one civil tax fraud prosecution by the IRS, and senior members of the Division have, on numerous occasions, lectured to various federal law enforcement agencies on the detection and prosecution of commodity-related wrongdoing. The Division of Trading and Markets has conducted a number of training sessions for employees of other federal agencies, such as the IRS.

Cooperation in prosecutions can involve assigning staff investigators to work with a United States Attorney's office in preparing a case for trial and providing testimony, as was done in a recent action in the northern District of Illinois alleging wire fraud, conspiracy, false representation of exchange membership, and aiding and abetting violations in connection with a fraudulent trading scheme conducted on the floor of the Chicago Board of Trade. Four individuals were convicted. Division investigators also have appeared or submitted affidavits as expert witnesses on aspects of futures trading or the futures markets.

As you are aware, the scope and even existence of law enforcement investigations, particularly criminal investigations, generally is confidential. Premature disclosure of investigative information can impede effective law enforcement. Indeed, in criminal enforcement matters, grand jury secrecy provisions and other considerations often restrict the disclosure of specific details about a criminal investigation even when the investigation and subsequent prosecution have been completed.

TASK FORCE PARTICIPATION

The Commission was instrumental in setting up both the Southern California Fraud Task Force (established in December 1985), and the San Diego Boiler Room/Investment Task Force (created 5 months later). The purpose of both task forces is to focus the efforts of various state and federal law enforcement agencies which are responsible for the investigation and prosecution of investor fraud. The Commission's Division of Enforcement has been an active participant in both Task Forces since their inception. In addition, through its Division of Enforcement, the Commission participates in a boiler room task force recently formed by the United States Attorney's office for the Southern District of Florida.

The Commission is also one of the original members of the Department of Justice Securities and Commodities Fraud Working Group. The group was organized to facilitate and encourage effective prosecution of fraud involving securities and commodities. Participants include various United States Attorneys, the SEC, FTC, FBI, IRS, the National Association of Attorneys General, and various securities and futures exchanges. Senior members of the Division of Enforcement have been participants in the Working Group for the past year.

STATE FEDERAL LIAISON UNIT

The State Federal Liaison Unit of the Division of Enforcement has conducted about a dozen training sessions for FBI agents at the Bureau's training academy in Quantico, Virginia. In addition, many federal enforcement personnel, including special agents of the FBI, IRS, Postal Inspector, Customs Service, Federal Trade Commission, and Securities and Exchange Commission, have attended 50 enforcement seminars and workshops which the State Federal Liaison Unit has conducted throughout the United States since 1985. An estimated 1,500 law enforcement officials have attended the seminars.

FEDERAL CRIMINAL CASES IN WHICH THE DIVISION OF ENFORCEMENT ASSISTED IN INVESTIGATION AND/OR PROSECUTION IN FISCAL YEARS 1986, 1987, 1988 AND 1989 TO DATE

Case title and docket	No. of defendants	No. of convictions
U.S. v. ***Ross A. Barnard,*** Cr. No. 89–40 (N.D. Ill. 1989)	2	Pending.
U.S. v. ***Daniel L. Bayer,*** Cr. No. 89–39 (N.D. Ill. 1989)	16	Pending.
U.S. v. ***Carl H. Bertrams,*** Cr. No. 88–975 (N.D. Ill. 1988)	3	Pending.
U.S. v. ***Walter S. Josten,*** Cr. No. 88–644–1 (N.D. Ill. 1988)	8	Pending.
U.S. v. ***John D. Riss,*** Cr. No. 88–640 (N.D. Ill. 1988)	1	1.
U.S. v. ***Denise Bigelow,*** Cr. No. 88–639 (N.D. Ill. 1988)	1	1.
U.S. v. ***Paul M. Kelly,*** Cr. No. 88–638 (N.D. Ill. 1988)	1	1.
U.S. v. ***Marvin J. Morrison,*** Cr. No. 88–285 (D. Co. 1988)	1	1.
U.S. v. ***Thompson B. Sanders,*** Cr. No. 88–104 (N.D. Ill. 1988)	4	4.
U.S. v. ***Jeffrey G. Donnelly,*** Cr. No. 88–102 (N.D. Ill. 1988)	1	1.
U.S. v. ***Robert Hitch,*** Cr. No. 88–101 (N.D. Ill. 1988)	3	3.
U.S. v. ***William A. Howe,*** Cr. No. 88–75 (D. Mass. 1988)	1	Pending.
U.S. v. ***Barbara Ann Skorupskas,*** Cr. No. 87–80923–DT (E.D. Mich. 1987)	5	2.
U.S. v. ***David Meek,*** Cr. No. 87–6009 (S.D. Fla. 1987)	1	1.
U.S. v. ***Terence Quinn,*** Cr. No. 87–389–MA (D. Mass. 1987)	1	Pending.
U.S. v. ***Jacob David a/k/a Jack Rose,*** Cr. No. 87–313 FMAG (E.D. La. 1987)	8	8.
U.S. v. ***Mark Philip Sabatini,*** Cr. No. 87–188 DLJ (N.D. Cal. 1987)	1	1.
U.S. v. ***Gary E. Halstead,*** Cr. No. 3–86–332–R (N.D. Tex. 1986)	1	1.
U.S. v. ***Carl M. Tipton,*** Cr. No. 86–20104 (W.D. Tenn 1986)	7	7.
U.S. v. ***Winford MacLeod,*** Cr. No. 86–696–1 (N.D. Ill. 1986)	1	1.
U.S. v. ***Terence M. King,*** Cr. No. 86–511 (N.D. Ill. 1986)	1	1.
U.S. v. ***Richard J. Quiter, Sr.,*** Cr. No. 86–210 (N.D. Ill. 1986)	1	1.
U.S. v. ***Todd Fisch,*** Cr. No. 86–173 JMI (C.D. Cal. 1986)	8	8.
U.S. v. ***Keith Grimes,*** Cr. No. 86–11 (C.D. Cal. 1986)	4	4.
U.S. v. ***William A. Slavicek,*** Cr. No. 85–384–1 (N.D. Ill. 1985)	1	1.
U.S. v. ***Jack Rose,*** Cr. No. 85–267 (N.D. Ill. 1985)	7	6.
U.S. v. ***Bonnie E. Frost,*** Cr. No. 85–211–1 (E.D. Wash. 1985)	1	1.
U.S. v. ***Orville W. Moeller,*** Cr. No. 85–210–1 (E.D. Wash. 1985)	1	1.
U.S. v. ***Thomas D. Morse,*** Cr. No. 85–142–CR (E.D. Mo. 1985)	1	1.
U.S. v. ***Rickey Wayne Reynolds,*** Cr. 85–94(1) (W.D.N.C. 1985)	4	2.
U.S. v. ***Rickey Wayne Reynolds,*** Cr. No. 85–93 (W.D.N.C. 1985)	1	1.
U.S. v. ***John E. Keller,*** Cr. No. 84–20235 (W.D. Tenn. 1984)	7	6.
U.S. v. ***George Nelson,*** Cr. No. 84–293 (S.D.N.Y. 1984)	7	7.
U.S. v. ***Richard Feldman,*** Cr. No. 81–747 (N.D. Ill. 1981)	2	2.
Totals	113	75

Editorial note: 34 case titles and dockets were cited.

I.10. A listing of all enforcement actions brought by the CFTC against designated futures exchanges since April 1975. For each case, please specify the nature of the violation alleged, the penalty sought by the Division of Enforcement, and the penalty finally assessed, if any.

A.10. Since its inception, the Commission has brought a total of 12 enforcement actions against registered futures exchanges. As a result of these actions, the Commission imposed a total of $540,000 in civil penalties, and 8 cease and desist orders, as well as other relief such as specific undertakings to address particular alleged deficiencies. One case is pending. The cases, sections of the Act and Commission regulations allegedly violated, and sanctions are listed on the attached table.

ENFORCEMENT ACTIONS AGAINST EXCHANGES

Case name and Docket No.	Section(s) of act alleged	Section(s) of regs. alleged	Penalty assessed
Chicago Board of Trade, 80 C 22 (N.D. Ill.) (1980).	5a(12)	1.41	Dismissed.
Chicago Mercantile Exchange:			
87-6 (1987)	5a(8), 5a(9)	1.12(e), 1.51, 1.52	Pending.
80 C 3626 (N.D. Ill.) (1980).	5a(12)	1.41	Dismissed.
COMEX:			
85-25 (1985)	5a(8), 5a(9), 6b	1.52, 1.53, 8.07	$75,000; cease and desist.
85-7 (1985)	5a(8)	1.51, 1.53, 8.07	$70,000; cease and desist.
79-24 (1979)	5a(1), 5a(12), 6		$5,000; cease and desist.
Kansas City Board of Trade, 85-6 (1985).	5a(8)	1.51, 1.53, 8.06	$60,000; cease and desist.
MidAmerica Commodity Exchange, 77-20 (1977).	5a(8), 6b	1.51, 1.53	$50,000; cease and desist.
Minneapolis Grain Exchange, 88-27 (1988).	5a(8)	1.51, 1.53, 8.06	$30,000; cease and desist.
New York Mercantile Exchange:			
81-23 (1981)	5(f), 5a(2), 5a(8), 6(a), 6b	1.50, 1.51, 1.53, 8.05, 8.06, 8.07.	$200,000; cease and desist.
77-14 (1977)	5(f), 5a(8)	1.51, 1.53	$50,000; cease and desist.
Pacific Commodity Exchange, 76-17 (1976).	5a(8)	1.51	Contract market designation revoked.

I.11. A discussion of all instances the CFTC is aware of in which data produced by an audit trail system implemented by an exchange under 'CFTC rule 1.35 has been offered into evidence in a court of law, an agency adjudication, an exchange disciplinary proceeding, or any other legal forum.

A.11. Audit trail data is intended to provide a physical record of all trading activity, including the sequence of trades. As described in Commission Rule 1.35, such data includes virtually every written record of a trade created and maintained by traders and exchanges, including order tickets, confirmations, trading cards, exchange time and sales reports, exchange trade registers, and, since 1987, a one-minute timing of trade executions. Responses to previous questions discussed generally how exchange compliance staff and the Commission's staff make use of audit trail data to conduct trade practice surveillance.

Complete investigations, whether by the exchanges or the Commission, require the examination of all relevant audit trail data, including customer order tickets, trading cards, and time and sales reports. Once a proceeding is instituted, proof of any trade practice violation requires evidence that certain trading occurred or was falsely recorded. It is typically those audit trail documents created contemporaneously with the execution of trades, such as order tickets and trading cards, that are the underlying source for evidentiary reconstruction of trading activity and the best evidence of a trade.

Each of the Enforcement actions alleging trade practice violations that are listed in response to question 2, above, utilized audit trail data. Seven of those cases thus far have involved an evidentiary hearing, while 20 settled without a hearing. Two cases remain in the pre-trial stages. In addition, nine statutory disqualification cases were based on findings of trade practice violations in previous exchange or other proceedings, and did not require the Commission to prove independently the underlying conduct.

Since July, 1987, exchanges have initiated and settled or tried the following cases based on audit trail data and involving trade practice or audit trail rule violations:

- *All futures exchanges* have disciplined approximately 249 members for trade practice violations and 119 members for audit trail rule violations based on audit trail data. Some of these cases were resolved through settlement and others were resolved through disciplinary hearings.
- *The Chicago Mercantile Exchange* ("CME") has disciplined 123 members for trade practice and 9 members for audit trail violations based on audit trail data. In at least four of the trade practice cases, the one-minute imputed times from the CME's audit trail were admitted into evidence at disciplinary hearings.
- *The Chicago Board of Trade* has disciplined 56 members for trade practice and 16 members for audit trail violations based on audit trail data.

The CHAIRMAN. Thank you very much, and I appreciate the material that you have provided and the cooperation you have given us. Let us start with the oversight of the exchanges.

During the last 2 years, the CFTC has issued rule enforcement reports on virtually every futures exchange, and you provided those to the committee. I think we have them here, do we not? I have not read every one of them. I have not read half of them. I have skimmed through a couple, and I have some idea of what we have had in the last couple of years.

Are you currently concerned about the level of intensity of rule enforcement efforts at any one of the exchanges? Are there any of the exchanges causing you special concern right now? You may want to speak up with the answer. A lot of people sitting behind you sort of whipped out their notebooks on that one.

Dr. GRAMM. Well, as you know, we have been conducting these rule enforcement reviews for a number of years, and, in every rule enforcement review we have conducted, we have made recommendations for changes. Generally, these recommendations have been accepted. In the most recent rule enforcement review, the one which the GAO has reported on to you—a rule enforcement review on the Chicago Board of Trade—the review covered a number of areas including, a review of the exchange's progress in implementing the 1 minute time sequence performance standard that we call the "enhanced audit trail," as well as their disciplinary programs and their market surveillance programs. We found that in those areas, there were some recommendations that were made, but they were generally meeting the requirements.

One area that we found was deficient and we thought needed greater improvement, was in the area of using their own system of data to internally generate investigations of trade practice abuses. That was one area that we felt that improvement was needed.

The CHAIRMAN. This is the Chicago Board of Trade you are talking about?

Dr. GRAMM. Yes. At the Board of Trade that there were a number of trade practice investigations that were generated from tips and other sources, external to the exchange's computerized surveillance system. However, there is new trade data information that is generated from the enhanced audit trail. We felt that there should be increased effort in using those data more effectively to generate more investigations.

The exchange has indicated that they will be, indeed have been, responsive to that. I understand that they will be putting a fair amount of new personnel and new resources in place aimed at improving their investigative efforts and we will be monitoring those efforts for effectiveness.

The **Chairman**. Do you have any exchanges on sort of a special list for intense or more intense scrutiny?

Dr. **Gramm**. We keep all of the exchanges under a regular schedule of scrutiny, with particular emphasis on the exchanges where previous rule enforcement reviews have identified areas for concern. In the past when we have identified areas where exchange improvements are needed, we have made specific recommendations. We have found them to be very responsive to making the changes that we recommend. Frankly, the responsiveness is partly because these rule enforcement reviews are public documents. Making such inspection reports public is really unusual, I think, for a regulator to do. As I stated earlier, the exchanges themselves want to have markets that are viewed as being safe and not riddled with abuse.

The **Chairman**. At the beginning of this hearing, I put in the record the New York Stock Exchange letter, and I took the CFTC data that you gave us concerning the size and budgets at the compliance task of each of the futures exchanges and, put them into the charts which we have up here now. Are you satisfied with the resources the exchanges themselves are putting into compliance—I am talking about both the size and the quality, quantity and quality, of the staffs—or should they be higher? Are there any particular exchanges that should be putting in more?

Dr. **Gramm**. In the past we have identified several exchanges which we felt needed to increase the size of their compliance staff, and we have made such recommendations in our rule enforcement reviews.

The **Chairman**. How do they react?

Dr. **Gramm**. I was just checking, the Minneapolis Grain Exchange was such an exchange, and their response was to make the changes that we had recommended. Obviously, we continue to monitor their compliance resources for sufficiency.

The **Chairman**. Well, let me ask you this. You have made recommendations for staff increases at certain of the commodity exchanges. Is there anyone that said no or has not followed your recommendations?

Dr. **Gramm**. If they did not——

Ms. **Corcoran**. Not really, but to the extent that the Minneapolis Grain Exchange did not——

Dr. **Gramm**. Was slow.

Ms. **Corcoran** [continuing]. They were slow.

Dr. **Gramm**. That is right. We brought a case.

Ms. **Corcoran**. We brought an enforcement case.

Dr. **Gramm**. That is right. And they have followed our recommendations. We brought a case against the Minneapolis Grain Exchange, because we felt that their response to our recommendations was not sufficient and timely. So we brought a case, and the exchange settled and since then increased its staff.

The **Chairman**. Has everybody else followed your recommendations?

Dr. **Gramm**. Yes.

The CHAIRMAN. The reason I ask is that, in your rule enforcement report on CBOT, you criticize that exchange for failing to hire five additional new investigators for its staff. Has that problem been solved?

Dr. GRAMM. They have indicated informally—I just received a letter today that they will do everything that we have asked them to do. They will take our recommendations and will implement them. Although we have given them a little time to respond more formally, we have already received an informal response. I received a verbal response from the exchange as well as a brief letter just last evening stating that the exchange intends to be fully responsive to the recommendations we made including committing funds and staff to trade practice investigations.

The CHAIRMAN. Then assuming CBOT hires those five investigators, and the Minneapolis Exchange follows your recommendation, then can I understand you to say that you are satisfied with the level of resources being committed by the exchanges to compliance, quantity, and quality?

Dr. GRAMM. As of this time. Of course, I would qualify that response by saying that this whole oversight process must be responsive to change, and that is why we continue to do periodic rule enforcement reviews. Conditions change. We may get more information. We certainly will be getting more information, at least as a result of the investigation.

The CHAIRMAN. But given today's conditions and today's compliance, you are satisfied with the quantity and quality today?

Dr. GRAMM. I believe we are, and——

Ms. CORCORAN. Based on the information we have before us.

Dr. GRAMM. Our Division of Trading and Markets is satisfied today that the exchanges have systems in place designed to carry out the Commodity Exchange Act.

The CHAIRMAN. Well, I have looked at the entries for the CBOT and the Chicago Merc. The Chicago Merc's compliance budget seems a lot higher. CBOT appears to have almost the same size compliance staff. Why is that? Does anybody know? I mean, the budget is much higher in one. The number of the staff is about the same.

The Chicago Board of Trade compliance budget is $3.5 million with 83 people. The Chicago Merc staff is 89 people, just 6 more, but their budget is $7.8 million, a little bit more than double.

Dr. GRAMM. I think in compliance that includes the computer support systems, as well. So there may be a difference in the dollar amount. Do they also supplement with other personnel, contract personnel?

Ms. CORCORAN. Yes, it is the computer systems—computer and personnel. When they add the additional resources promised at the Chicago Board of Trade their budget will increase.

The CHAIRMAN. But I mean the Board of Trade must have a computer system too, though?

Dr. GRAMM. That is right. But the Board of Trade is also going to be increasing both staff as well as the——

The CHAIRMAN. Let me ask the question this way, and then you can supply me a very specific answer for the record, if you would. Why is there the discrepancy between the Board of Trade and the

Mercantile Exchange in dollar amounts, a huge discrepancy considering the fact that there is approximately the same number of people? If part of that is because of computer expenses, well, then compare the computer expenses. So rather than have you give off-the-cuff answers, if you could, you supply that one specifically for the record.

Dr. GRAMM. Sure. Absolutely.

[The requested material follows:]

The data originally submitted to the committee regarding the compliance budgets of the Chicago Mercantile Exchange and the Chicago Board of Trade have been revised so that the amounts for both exchanges now have been computed to reflect comparable categories of expenditures. As a result, those exchanges compliance budgets for 1988 have been computed as $3,931,000 and $3,553,000, respectively.

The CHAIRMAN. I notice one thing that varies quite a lot is the monetary sanctions imposed by each exchange for trade practice violations. Looking at the chart from your prepared statement I see that the New York Mercantile Exchange, the Nation's third largest market, gave out zero sanctions in 1987. Amounts for other markets ranged considerably; the Chicago Merc had $2 million in sanctions, the Board of Trade had $190,000, Comex had $330,000, and so on. NYMEX had zero. Now the compliance staff size had a major increase for the exchange. Is there any reason for this?

Is it just that there were no problems there? The compliance staff went up. The sanctions were zero. Everybody else had some sanctions. I mean I am not suggesting that we have sanctions for the sake of sanctions, but why such a low number here?

Dr. GRAMM. Well, I think——

The CHAIRMAN. Or am I missing something?

Dr. GRAMM [continuing]. You are putting your finger on part of it. Looking at the sanctions and the number of cases brought, I think, can give you an indication of the program, but it does not necessarily tell you everything about the program which is why our reviews focus on other indicators as well. The fact of the matter is that zero cases might be an indicator of no violations or of no surveillance.

And so it is hard to make those judgments offhand. But numbers are some indication of intensity of effort. I would like to, Mr. Chairman, just for a minute go back to your earlier question to make one point. While we can compare exchanges and look at how they run their programs and what amounts they spend on these programs, it is important to remember that exchanges use different mixes and different types of programs to carry out their responsibilities.

One of the things that this Commission has stressed in its general oversight role is to look at performance rather than require each exchange to have the exact same kinds of systems or programs or even compliance budget expenditures. I think it is valuable to look at these issues, but again part of the self-regulatory function is to allow the exchanges to find the right mix of programs consistent with their resources to carry out the Commodity Exchange Act.

But we did, going back to the question about the NYMEX, for example, we did criticize NYMEX in the rule enforcement review for not having sufficient staff, and they also responded to our recommendations.

The CHAIRMAN. Well, let me ask you just a couple of questions about these recommendations, and then I want to yield to Senator Lugar. Your recent rule enforcement review of the Chicago Board of Trade was fairly critical of both the exchange's audit trail and its trade practice oversight program.

Now on trade practices, you complained that the exchange still had not resolved deficiencies from your report 2 years ago, or 3 years ago now, in 1986. How are you going to make sure the exchange fixes the problem this time if they did not do it after your 1986 report?

Dr. GRAMM. What we have is first of all a commitment from the exchange, and we have asked them to report to us specifically on their response to our report. Then we have other tools at our disposal such that if we believe that the exchange has not implemented our recommendations, we can take other action including enforcement action against them.

The CHAIRMAN. Which sort of follows into my next point. Your prehearing package shows that going back to 1985, you sued the exchanges five times for failures in their self-regulation. You had two 1985 suits against Comex, a 1985 case against the Kansas City Board of Trade, a 1987 suit against the Chicago Merc, and a 1988 suit against Minneapolis Grain Exchange. Now, how do we read this? Do we say this is a great showing, that you are being really tough and coming down hard on the self-regulators who should be doing the job themselves? Or should we say, gee, we should really be worried about this, that the exchanges needed to have you do this? How do you read it?

Dr. GRAMM. Maybe some of both. Again, you have to remember that even so, the rule enforcement review process is a relatively new process, and that it is important that we show the exchanges that we stand by our recommendations and we expect responsiveness as well. So I think perhaps it shows maybe a little bit of both. We are tough. Exchanges are learning, and I think they are all being very responsive.

I think that over the years that we have been doing these reviews that you have seen improvements in exchange systems. You have seen their disciplinary systems improve in terms of increasing numbers of cases and increasing fines and penalties as well. One could argue that that is a result of our oversight.

The CHAIRMAN. Now this rule review process is what, 10 years old?

Dr. GRAMM. When did we start the first rule reviews as a matter of making public our report card?

Ms. CORCORAN. Could I say that the rule review process itself is several years old, but actually it was only in 1982 when the National Futures Association took over the direct regulatory responsibilities of the Commission with respect to nonmember firms that had substantially occupied Commission resources, that oversight reviews became a focus. I mean we had responsibility for the financial compliance and other compliance of all nonmember firms until the NFA came onboard. So we spent a lot of time on direct surveillance until 1982, and it was really in 1982 with the issuance of the first critical review of the Chicago Board of Trade that we would say that the really significant series of rule enforcement reviews and the significant exchange responses commenced.

Dr. **Gramm**. This is Andrea Corcoran who is the director of our Division of Trading and Markets which issues the rule enforcement reviews.

The **Chairman**. Thank you. Let me yield to Senator Lugar. I have gone over my time anyway.

Senator **Lugar**. Thank you very much, Mr. Chairman.

Mrs. Gramm, in my opening comment I mentioned that it seems to me to be important for our consideration, prior to reauthorization, to have a much better idea of both the strengths and weaknesses of electronic trading systems.[1] I know you cannot provide that comprehensively today, but clearly at the time of the GAO report the witnesses then pointed out that there were strengths and weaknesses. We were focused that day on the audit trail situation, and attempting to try to find the strengths and weaknesses of the progress we have had there.

I am hopeful you will be able to provide for members for the committee an objective analysis of what it would mean to go to a full electronic trading system as opposed to open outcry or other methods that are now employed because if we were to move in that direction we want to know the downsides as well as the possibilities.

The second request that I made earlier but I want to underline is really a thorough list of the recommendations or the requests that CFTC made in the reauthorizations of 1982 and 1986 and that were denied by the Congress. It is my recollection that CFTC in attempting to do its job asked for additional authority, and on occasion that was granted. Most of it, I believe, in 1982 and 1986, but some was denied. As an example of that, when we got into the audit trail system, there was, as you will recall, quite a dispute with members of the industry and members of the committee as to the nature of that, and this 1 minute system that you have described today was the outgrowth of the compromise in that respect.

We heard the other day from GAO that one of the problems of the current situation is that it relies on the data given by the traders. I think there was an estimate, if I remember correctly, that about 85 percent of the reconstructed trading times, are verifiably accurate and 15 percent not. This is due in part to either no data or inaccurate data entered by traders. The audit trail is bound to suffer by that amount. There may be, in fact, more instances than the 15 percent of inaccuracy, but there are at least those many gaps identified at this point.

This leads me to ask you what, in fact, is your assessment of the audit trail system, as we now have it, and I suppose specifically I would like to ask you to underline the point in your statement that you observe the audit trail is used more to support disciplinary action than to identify abuses in the first place. This seems to me to be maybe accurate of historical fact but not necessarily predictive of what ought to be, and I suppose that I would like to ask you is what kind of an audit trail or what kind of work by the CFTC would use that audit trail to highlight in advance the possibilities of problems as opposed to simply having something to rely upon when cases finally go to disciplinary action or to court action.

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[1] See Electronic Trading Systems, pages 112 to 114 for a written response.

Dr. **Gramm**. You have asked a lot of very good questions. Let me mention first of all, as you know, this is a very innovative market. It is one that is rapidly changing and that faces a lot of competition. There is a lot of competition in these markets not only domestically among the exchanges but internationally as well. With respect to electronic trading, we have recently approved a proposal by the Chicago Mercantile Exchange to use an electronic trading system for after regular trading hours. And we look forward to the implementation of that system.

Several aspects of the system, I think, are interesting with respect to trade practice activity. There are several factors in that particular system that might enhance, or let us put it this way, might limit the potential for certain types of trade practice abuses.

For example, in the kind of system that is envisioned by Globex the system is such that you really are taking out the personal nature of the transaction between two individuals. So the potential for prearranged trading may be reduced because there might be less incentive for prearranged trading if you cannot really tell whether or not you are going to be able to execute the trade opposite the person with which it has been prearranged. In addition, the system contains significant extra information such as execution information to the nearest second, that is "to-the-second" audit trail data. These data should enhance the ability to detect and thus would limit the ability to have certain kinds of violations.

Again, there are many different electronic trading systems, different kinds in different countries in different markets as well. And I think what the impact will be on potential trading abuses really depends on the system and how it works. So it is a little difficult, in the abstract, to say what will be the impact of computerized trading, but it is a little bit easier to look at a specific proposal where you see the whole program and how it is going to be implemented and discuss in that context what the impact would be. I would be happy to provide that kind of information for you.

[The Electronic Trading Systems material can be found on pages 112 to 114.]

Senator **Lugar**. I would just like to underline the point that you made. Obviously it is logically persuasive that if prearranged trading could be virtually eliminated, and if you have an audit trail down to the second that you ought to proceed to electronic trading with a vengeance. You know in short, if it can operate during the time the exchanges are not in session and be adequate, the question is certainly logical why not during the normal trading hours?

The problem I have is that clearly there must be some unintended consequences of all of this, and I really want a rigorous analysis now of precisely what these trading systems are. We are going to have to make some decisions as to how far we progress with this. I made the point in the last hearing that folks may believe that business as usual is fine, but I am not one that believes that. If we are on the threshold of something that makes a very significant breakthrough in terms of confidence in our trading system, we ought to go after it.

But while we are doing that, we really need to know quickly what the problems are of electronic trading. The advantages, it seems to me, are manifest, and I hope that you will help us with a rigorous analysis of any trading systems that are offered in addition to the Globex or whatever the exchanges have in mind.

Dr. **Gramm**. We would be happy to do that for you and for anyone else who would be interested. Our Division of Trading and Markets spent quite a bit of time and effort in reviewing that particular proposal for all factors not only trade practice surveillance, but also with respect to financial surveillance, et cetera. We would be happy to provide that analysis to you.

You also asked about—and we will provide for you responses to the requests that have been made in the past. The CFTC has long identified the time sequencing of trades as an important issue and, as you know, the 1 minute time performance standard for the audit trail has been implemented.

Such systems are continually being improved. They have been in place for maybe a year and a half. They are still being improved. The exchanges clearly are still learning how to best use the data most effectively in their own oversight and compliance procedures. I would like to clarify the 85 percent figure that you heard. The accuracy and the verifiability of the audit trail data are things that the Commission has asked the exchanges to improve.

We have also asked by a recent letter that the exchanges give us a timetable for these improvements. I would say, though, that 85 percent accuracy does not mean that 15 percent of those trades are lost, or that their times are not usable for reconstructing trading. Let me also back up and say that the system, these new audit trail systems are different at different exchanges. We imposed the 1 minute standard as a performance standard. The actual design of each system is different for each different exchange.

So, for example, the CME and the CBT, use a computer algorithm that helps to identify the actual minute of trade execution. And we have asked in our CBT rule enforcement review that the CBT improve its ability to verify the times that system produces.

In other systems a trader enters the time by a hand-recordation system, for example, as they do on the Kansas City Board of Trade. The trader himself will enter that time to the nearest minute. The trader is supposed to put down an accurate time, but what we ask is for verification that he did. For example, if a trader puts in 9:13 as a time, a way to verify it is to look to see what time the trader on the other side of the trade puts in. If that trader puts in 9:18, for example, then we say that time is inaccurate.

Although the two traders' time was 5 minutes apart, the trade time is viewed as not accurate. It is not, however, totally lost in any way and the 5-minute period in which the trade occurred can be used to reconstruct trading. I just wanted to clarify that. Our rule enforcement reviews do discuss and look at the level of confidence, the level of accuracy, as well as the verifiability of these data. The other point that you make and the point that I make in the prepared testimony is that these data are used to support investigations, and in some cases they are used to identify what may be suspicious trading practices.

But I would point out that trade practice investigations are very difficult, resource intensive investigations, and the new computerized systems have vastly improved our ability and efficiency to undertake these types of investigations.

But let me also point out that while you can identify some suspicious behavior by systems which reflect suspicious trading patterns, that does not necessarily mean that you can find cases all that easily. For example, to find someone who is trading ahead of a customer when that broker has an executable order ticket in his hands so he knows he has a customer order, but he enters an order for himself before his customer's order in that product or a related product—I think Senator Bond mentioned the last time that while looking at a screen, he said here is somebody that has a CTI-1 trade for himself and then a CTI-4 customer trade a few minutes later. But——

Senator LUGAR. Seconds later.

Dr. GRAMM. A few seconds later. First of all, what you need to do is to determine whether or not the broker has an executable order in his hand. You have to go to the underlying documents. I would also point out that before the advent of the enhanced audit trail the amount of paper that you would have to go through to find that kind of trading ahead behavior was enormous. I mean it took an enormous amount of time.

The other thing that is important to remember is that if a floor broker uses an accommodating broker to carry out some unlawful activity, you will not necessarily be able to pick it up so easily in the first pass on the data tapes because after all you would have a trade between one broker and another. There are a lot of trades that occur between brokers. And there are a lot of legal trades that occur between brokers.

The difficulty, then, is to identify patterns that look suspicious. When you do you always have to get the evidence to try to determine whether or not it supports the hypothesis that it is illegal activity versus an hypothesis that it may be legal. That is a difficult project and may involve additional research.

Senator LUGAR. I have just one final question. I raised the question about the CFTC's recommendations in the past really as an opportunity for the agency to indicate its own alertness. Sometimes if the agency is criticized you ought to have the defense that you asked for a number of things that you did not get.

Dr. GRAMM. Right. Absolutely.

Senator LUGAR. And you may not want all that you asked for in the past, too. You may have decided that the recommendations were not warranted after all. My final question is, given the fact that the last review of Chicago Board of Trade was conducted in 1986 and had a number of recommendations for action by the Chicago Board of Trade, why did CFTC wait until 1989 for this review and to conduct another survey of the audit trail without acting upon the initial recommendations? My question, I suppose, in regard to this review process is, is it an adequate way to monitor compliance, and if after you have recommendations for change that were manifested there at CBOT in 1986, why did you not act upon them, or why did we wait until 1989 for another review to see whether we should move ahead?

Dr. **Gramm**. First of all, we typically have a target period where we look at the systems and the documents, et cetera, and then do our report. We had ongoing conversations with the CBT with respect to our recommendations, and they had been trying to implement our recommendations. I think another aspect is that the recommendations we make refer to effectiveness of systems. So we are always looking at output especially if the changes made do not produce an effective result or the desired goal.

The target period for the last CBT review was July 1987 to April 1988. During the time of that review period we identified some recommendations and improvements that needed to be made, and they were attempting to make some of those improvements even during that time period as well. But again, in looking at the results we felt that they still were not producing the kind of results that we would like to see, particularly in the area of generating their own internal trade practice investigations from the computer system and data available.

Senator **Lugar**. Thank you very much. Thank you, Mr. Chairman.

[Material supplied for the record follows:]

Electronic Trading Systems

QUESTIONS SUBMITTED BY SENATOR LUGAR

Question. Mrs. Gramm, in my opening comment I mentioned that it seems to me to be important for our consideration prior to reauthorization to have a much better idea of both the strengths and weaknesses of electronic trading systems.

Answer. Computer technology is integral to the financial industry. As a consequence, the Commission recognizes the importance of fully understanding the potential advantages and disadvantages of computerization and of adequately exploring the regulatory issues such technology raises. In the past, the Commission has had occasion to review the use of computers in several contexts such as computerized trade reconstruction systems used for audit trail purposes and computerized option margin systems.

Although several computerized trading systems for derivative products have been implemented in recent years, such as the Intex in Bermuda, the Soffex in Switzerland, and Instinet, a securities trade matching system in the United States, to date these systems have not generated large trading volume. Computerized order execution systems raise issues beyond those raised by automated order routing systems such as those in place in the securities markets and under development in the futures markets. The Commission recently approved the Chicago Mercantile Exchange's Globex system, the first electronic trading system on a U.S. commodity exchange. At this point it appears that Globex will be materially different from other electronic futures trading systems in that it will be based on extending the hours of existing liquid open outcry markets.

In reviewing a proposed electronic trading system, the Commission analyzes whether the proposal is consistent with the Commodity Exchange Act and the regulations thereunder. The system must provide for the open and competitive execution of orders. It also must be designed to achieve the dual objectives of the Act: market integrity and customer protection. The likelihood of economic viability of a proposal is not a criterion for Commission approval. That is a matter within the business judgment of an exchange.

In reviewing Globex, the Commission took the following steps. It published in the Federal Register a request for public comment on the proposal. It sent a comprehensive set of 70 questions concerning the proposal to the Chicago Mercantile Exchange, including questions developed by CFTC computer personnel; conducted extensive further follow-up with Chicago Mercantile Exchange staff regarding a range of issues; and consulted with foreign regulators. Based on a review of the public comments, the CME's responses, and Commission staff's own inquiries, Commission staff prepared a lengthy analysis of the proposal in light of the requirements of the Act and the Commission's regulations. I am providing a copy of that memorandum.[2]

The Commission considers review of electronic trading systems to be an ongoing process. With regard to Globex, the Commission will review results of system testing and trade simulations to be conducted by the Chicago Mercantile Exchange later this year.

With regard to electronic systems in general, Commission staff is developing guidelines to be applied in connection with the review of each such proposed system. These guidelines would aid Commission staff in assessing the capacity of proposed systems to address the Commission's regulatory concerns. In addition, the Commission is cooperating in the study of computerized trading and clearing and settlement systems being conducted by the Office of Technology Assessment.

The following is a summary of the potential advantages and disadvantages, and open issues related to electronic trading systems:

ACCESS TO AND QUALITY OF MARKETS

—Electronic systems can increase access to the markets by facilitating extended trading hours, and by permitting entry of orders from locations away from the floor. However, increased access potentially raises certain trade practice and computer security issues discussed below.

—Electronic systems potentially could result in reduced costs for customers due to reduced staffing expenses for futures commission merchants, especially with respect to staffing necessary for 24-hour trading. On the other hand, such systems potentially could result in increased costs due to increased equipment expenses for futures commission merchants and due to the operational and administrative expenses that may be incurred if multiple systems are necessary to trade on different markets.

—The greater access potentially available through electronic systems could bring additional participants to the markets, thereby increasing competition. On the other hand, the costs of entry could be prohibitive for smaller exchanges and futures commission merchants, thereby reducing competition. In addition, restrictive covenants might be entered into by exchanges in order to make the initial development costs of establishing global networks economically feasible. Such covenants could erect barriers to competition.

—Electronic systems could increase liquidity as a result of increased access. On the other hand, they could decrease liquidity by spreading volume over longer trading hours, reducing trading by locals, and increasing costs to market participants.

—Electronic systems may provide increased efficiency in pricing by ensuring that all orders are exposed to one another. By contrast, physical limitations sometimes may impede such exposure in large and active pits.

—Electronic systems may be structured to distribute market information equally among all market participants, i.e., to eliminate informational advantages which floor traders currently hold over other market participants. However, this could reduce participation by locals and thereby reduce liquidity.

—Electronic systems may increase the efficiency of pit trading by fostering the development of on-line clearing systems, automated order routing systems, and other enhancements which could allow pit trading to compete with "black box" trading with equal efficiency.

—Electronic systems may decrease the need to rely on futures commission merchants and floor brokers for the quality of fills. However, electronic systems may accept fewer types of orders.

—Electronic systems may be structured to eliminate or reduce outtrades. That is, such systems may provide that trade execution or confirmation cannot occur unless the relevant data matches on both sides of a trade. This feature should improve order execution generally, expedite clearing and settlement, and reduce the financial risks incurred by futures commission merchants in connection with carrying uncleared trades.

TRADE PRACTICE

—Electronic systems permit a more precise and detailed audit trail, thereby making many trading abuses easier to detect and to prove. However, the ability to enter orders through widely-disseminated terminals may reduce the amount of scrutiny of trading by other market participants and potentially limit the opportunity for visual surveillance and other on-site supervision.

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[2] This memorandum is retained in the committee file.

—Abuses such as prearranged trading, fictitious trading, and kerb trading may be very difficult or impossible to commit through electronic systems. This is particularly true in electronic systems where the opposite trader is not disclosed. However, electronic systems may provide terminal operators with an opportunity to commit certain other abuses such as trading ahead of customers or wash trading.

—There may be types of trading abuses unique to electronic systems. The Commission is exploring this issue.

FINANCIAL INTEGRITY

—Electronic trading makes on-line financial surveillance possible for the Commission, the exchanges and futures commission merchants.

—Electronic trading could be used to narrow the time between the establishment of positions and the margining of those positions. Electronic trading also could foster the development of more efficient and timely settlement procedures.

—Electronic systems make it possible to enforce individualized position limits or credit controls automatically by programming such restrictions into the system. However, in the absence of such restrictions, electronic systems may increase financial risk to clearing members and, indirectly, to clearinghouses by increasing access to the system, making it easier for traders to establish unauthorized positions.

INTERNATIONAL ISSUES

—Increases in foreign-based business could create additional financial risks. There could be increased difficulty in collecting funds or enforcing judgments arising out of electronic trading in foreign countries because foreign courts or regulators may treat electronic trading differently under their laws. U.S. exchanges may be able to address such problems through exchange rules and by requiring choice-of-law agreements to be signed by system participants.

—Increases in foreign-based business could foster greater regulatory coordination. On the other hand, conflicting regulatory requirements could result if different nations assert jurisdiction over aspects of the same system.

COMPUTER SECURITY

—Computer technology raises unique questions of operational integrity and security. In electronic trading systems, security concerns include, among other things, the potential for unauthorized access and trading by individuals, and the potential for tampering with the computer system. There are mechanisms that should be established to minimize such potential abuses.

—The system should require proper terminal identification and require users to provide identification codes and passwords for access. Also, those that maintain the entry terminals, such as futures commission merchants, should provide measures to monitor and limit access to such terminals. Data entry should be restricted to a specific format to prevent a computer virus from being introduced into the system.

—In addition, limited physical access, along with functional separation of duties for those with access, should provide central computer integrity. For example, computer operators may not be allowed access to computer source programs. Integrity of trade data should be maintained through stringent backup and recovery procedures.

As the foregoing indicates, there are a number of open questions with regard to the advantages and disadvantages of electronic trading. In part, these questions can be answered only after experience with the operation of actual systems. The Commission believes that continuing development of electronic trading systems is an important element in maintaining the competitive position of U.S. exchanges in the global marketplace as electronic systems are being developed by foreign exchanges.

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
WASHINGTON, DC, *March 14, 1989.*

The Honorable WENDY L. GRAMM,
Chairman, Commodity Futures Trading Commission, 2033 K Street, NW., Washington, DC.

DEAR CHAIRMAN GRAMM: Thank you very much for testifying at our hearing on trading practices in the commodities futures markets on March 9, 1989.

Enclosed are questions submitted for the record by Senator Richard Lugar. We would appreciate responses to these questions by March 31. Please return your responses to Betsy Paul, Hearing Clerk, 328A Russell Senate Office Building.

Sincerely,

PATRICK LEAHY,
Chairman.

Enclosure.

QUESTIONS SUBMITTED BY SENATOR LUGAR

1. A March 1 Wall Street journal article (copy attached) argues that the problems with trading practice abuses on futures exchanges are as applicable to New York as they are to Chicago. What is your view of the effectiveness—the "intensity" to use the words of GAO—of compliance surveillance and disciplinary efforts on the New York futures exchanges?

2. In response to a question submitted to the Commission with Chairman Leahy's February 9 letter, the following statement was made by CFTC: "Effectiveness [of trade practice surveillance] is measured both in terms of the capability of systems in place and the results obtained through the use of such systems."

What standards or guidelines do you and the other Commission members use to measure the significance of the results of the exchange's efforts when evaluating exchange disciplinary records and surveillance and monitoring systems? That is, what objective standards do you apply to determine "effectiveness"?

3. On page 9 of Chairman Gramm's prepared statement there is a table setting forth data on trade practice investigations for the three largest exchanges from 1986 through 1988 (CBOT—represented about 47.5 percent of the trading volume in 1988; CME about 26.7 percent; and NYMEX about 11.7 percent). The table gives rise to a couple of questions.

(a) First, do you have any explanation for why the largest number of investigations in 1988 was initiated by the smallest of these three exchanges (130 by NYMEX compared to 128 by CME and 26 by CBOT)?

(b) Is this type of data valid for purposes of evaluating the effectiveness of enforcement efforts of an exchange or comparing enforcement efforts between exchanges?

(c) Comparing the data for all 3 years, a unexpected difference is evident between the NY exchange and the two Chicago exchanges. Specifically, at NYMEX the majority of investigations appear to have been initiated from internal exchange data and staff expertise, but in Chicago the majority of the investigations are the result of external information such as complaints. How do you explain this difference and is it significant?

[The March 1, 1989, Wall Street Journal article, "Violations Abound at New York Commodity Exchanges," by William Power and Stanley W. Angrist, staff reporters of the Wall Street Journal follows:]

VIOLATIONS ABOUND AT NEW YORK COMMODITY EXCHANGES

(By William Power and Stanely W. Angrist, staff reporters of the Wall Street Journal)

When the Chicago commodity-trading scandal broke early this year, many investigators began to wonder whether there were problems in New York's trading pits, too.

The real question, it's clear, isn't "whether," but "how many?"

A Wall Street Journal review of disciplinary records at the five major New York commodity exchanges shows that nearly 500 individual traders were cited for trading and floor violations last year. They paid out a total of nearly $1.5 million in fines.

Some of the actions were minor, such as the orange-juice trader fined $100 for "making noises which were disruptive." But about half the disciplinary actions brought by the exchanges involved serious allegations such as prearranged trading, improperly disclosing customer orders to other traders, wash sales, prohibited cross-trading and other practices similar to the wrongdoing being investigated by federal investigators in Chicago.

While investors might be comforted that the New York exchanges are policing themselves, there's no guarantee that exchange officials detect all, or even most, trading violations.

Indeed, the Chicago exchanges, particularly, have been getting heat from Congress for the relatively few disciplinary actions taken against members, especially at the huge Chicago Board of Trade. The U.S. Attorney in Chicago staged a two-year undercover investigation in the Chicago pits that allegedly uncovered major wrongdoing that had gone unpunished by the exchanges there.

Many investors wonder why the spotlight has been focused soley on Chicago. "I don't think the people in New York are morally any better than those in Chicago," says Gary Tilkin, editor of Accu Comm Futures Forecast in Ada, Mich.

In New York, one has to look no further than the executive suites of New York's two biggest commodity exchanges—the New York Mercantile Exchange and the Commodity Exchange, or Comex—to find trading violations during the same time frame of the two-year Chicago probe.

Comex Chairman John H. Hanemann, a gold trader, paid a $40,000 fine last year shortly before his election to settle Comex charges that he made "noncompetitive" and "prearranged" trades, and violated rules against taking the other side of customer orders—in other words, buying at the same time a customer is selling. At the time, Mr. Hanemann, who neither admitted nor denied any violations in the Comex settlement, said the situation was "a regretful thing that won't happen again."

To investors worried about how well the New York exchanges police their members, the record of the city's biggest exchange, the New York Merc, may be unsettling. The exchange—the world's oil-futures hub—reported the fewest cases involving improper trading practices last year.

The New York Merc reported less than a dozen such cases, involving less than $50,000 in fines, of its total 150 disciplinary actions involving $420,000 in fines. Most of the actions were for violations of decorum or failures to submit trading reports. A rare prearranged-trading case reported late last year resulted in only a $7,500 fine for one trader and a $5,000 fine for another. Prearranged trades bypass an exchange's open-outcry system, in which traders shout out their bids and offers.

A New York Merc spokeswoman says some of its major disciplinary actions against improper trading remain "not public." That may be the case, but for several months up to last year, the top trading watchdog at the New York Merc wasn't always at his post.

The exchange's former compliance director, Kevin P. Conway, who then was responsible for policing the exchange's busy oil and metals pits, "was engaged in other personal business activities on Exchange time," including out-of-state trips, according to a New York Merc report last year after an inquiry into both Mr. Conway, who has since left the exchange, and then-chairman William M. Bradt.

Mr. Bradt, for his part, resigned last August after the Commodity Futures Trading Commission, the futures industry's federal watchdog, criticized him for such things as taking fees from a Chicago trading house—apparently because he created an oil-options contract. Both men denied doing anything improper.

Besides the New York Merc and Comex, the New York exchanges are the Coffee, Sugar and Cocoa Exchange, the New York Cotton Exchange and the New York Futures Exchange, which is a unit of the New York Stock Exchange. All five futures marts operate side by side on a floor at the World Trade Center in Manhattan.

BROKERAGE FIRMS CENSURED

In addition to the many individual traders who were disciplined last year by the New York exchanges, Merrill Lynch Futures Inc., a unit of Merrill Lynch & Co., and Prudential-Bache Securities Inc. both were censured by the Comex for noncompetitive and prearranged trading. A Merrill Lynch spokesman said the case against the firm is "not true." A Prudential-Bache official stressed that the firm's case was settled "for the sake of disposing the case."

The Coffee, Sugar and Cocoa Exchange, which said it last year collected $155,950 in fines in 152 cases, refuses to let the public find out the names of traders disciplined by the exchange, the only U.S. futures exchange to be so secretive. But a regulatory official says about a third of the cases involved improper trading.

The coffee exchange's recalcitrance contrasts with the efforts of most exchanges to publicize their self-policing, and seems to contradict a CFTC rule requiring that disciplinary actions "must be made public." But the coffee exchange "wouldn't permit anyone to come through the look through these documents," says Janet E. Troy, an exchange spokeswoman.

Coffee-exchange officials point out that they post their disciplinary action for five days, but the bulletin board where notices are posted is in an exchange hallway restricted to members.

Aside from these disciplinary proceedings, professional traders say they see signs of possible trading problems in New York in the form of unusual price movements.

Many of the New York markets don't have the same frenzied volume of commodities trading as Chicago, but that's not necessarily good. An example of what can happen in a trading pit lacking volume took place Feb. 12, 1988, on the tiny Financial Instruments section of the New York Cotton Exchange. The trading involved the Finex's U.S. Dollar Index contract, which is based on a market basket of foreign currencies.

UNUSUAL PRICE DROP

Philip Gotthelf, president of Equidex Brokerage Group and editor of two commodity market letters, says he had an order in the Dollar Index pit to sell 63 contracts if the price dropped below a certain "bailout" price. On Feb. 12, bullish news on the dollar came out, and the dollar contract should have soared, he says. Instead, to Mr. Gotthelf's horror, the contract dropped to below his bailout price, and his contracts were sold.

Shortly afterward, the dollar contract rallied. The unusual price moves cost Mr. Gotthelf's customers about $15,000, he says, adding that he complained to the exchange.

Richard Jaycobs, Finex managing director, says the exchange investigated. While he wouldn't be specific, "the conclusion was that no broker acted in a suspicious manner," says Mr. Jaycobs. He says that Mr. Gotthelf was swamped by an order from another off-floor investor. In general, argues Mr. Jaycobs, an "aberrant move" in the market "doesn't necessarily mean that someone on the floor benefits."

Russell Wasendorf, a market letter publisher and adviser in Cedar Falls, Iowa, says no one can be sure what's happening on the exchange floors. But, "I find it odd that the government has elected to investigate in Chicago and not in New York."

Federal prosecutor Bruce Baird, head of the securities and commodities frauds unit in the U.S. Attorney's office in Manhattan, won't say whether the New York exchanges are getting the same treatment as Chicago's. But he adds: "I can say we do have active commodities investigations," though not necessarily involving traders. "I can't rule out anything," says Mr. Baird. But traders point out that the U.S. Attorney in Manhattan is busy with a massive probe of insider trading and other securities-law violations.

New York futures officials, while trying to distance themselves from the Chicago exchanges' trouble, have been quietly reevaluating their ethics procedures. After the New York Merc's difficulties with its compliance director and chairman, the 116-year-old exchange issued its first "ethics guidelines" for members.

Z. Lou Guttman, New York Merc chairman, said, "Last year we also doubled our trade-practice staff. The commitment is here."

In an official statement last month, the Futures Industry Association, the industry's national trade group, said that it "remains confident that the vast majority of futures market professionals conduct their business in accordance with the law." The statement was meant to reassure investors.

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR LUGAR

Q.1. A March 1 Wall Street Journal article (copy attached) argues that the problems with trading practice abuses on futures exchanges are as applicable to New York as they are to Chicago. What is your view of the effectiveness—the "intensity" to use the words of GAO—of compliance surveillance and disciplinary efforts on the New York futures exchanges?

A.1. Based on existing information and ongoing oversight, the Commission believes that each New York futures exchange generally has a surveillance system in place which should permit it to achieve the level of "intensity" in its compliance efforts necessary to meet its statutory obligation to maintain an affirmative self-regulatory enforcement program. The New York exchanges employ compliance systems and procedures which are similar to the systems and procedures used by other exchanges. As in the case of the Chicago exchanges, Commission staff has recommended improvements to the New York exchanges' compliance systems and programs in the course of oversight reviews and otherwise and will continue to do so.

The Commission, nevertheless, has brought enforcement actions, in the past, against the Commodity Exchange, Incorporated and the New York Mercantile Exchange alleging failures to enforce exchange trade practice prohibitions. The development and implementation of surveillance and disciplinary programs that are sufficient to meet the statutory requirement for continuing designation of an exchange as an approved market are ongoing processes, and the Commission has demonstrated its commitment to improving these programs through use of all of the oversight powers, including enforcement authority, at its disposal.

In reviewing the extent of the intensity of exchange self-regulatory efforts, the General Accounting Office identified three factors which it believed describe the degree of an exchanges' intensity of oversight efforts. These factors were the adequacy of the framework of controls, the number and nature of disciplinary actions taken on identified abuses, and the use of oversight results to improve the control system, target trends of abuse, and allocate scarce resources. GAO suggested that, together, these three factors could be used to assess the effectiveness of the New York exchanges' surveillance procedures and actions.

The Commission has developed its own standards when it assesses exchange programs to determine their quality and conformance with statutory and regulatory requirements. In particular, it reviews exchange compliance with the continuing conditions of designation specified in Sections 5a(8) and 5a(9) of the Commodity Exchange Act, in Commission Regulations 1.35, 1.51, 1.52, and 8.06 through 8.20, and in Guideline Two, as well as each exchange's degree of responsiveness to previous Commission recommendations. The Commission's standards for review of exchange programs, including those pertaining to the timeliness, effectiveness, and quality of such programs, are described below in response to Question Two.

The Division of Trading and Markets' most recent reports on the New York exchanges using these guidelines and standards are the New York Mercantile Exchange trade practice and audit trail report, issued on March 27, 1987, and a special inquiry report of NYMEX, released on August 25, 1988; the Commodity Exchange, Incorporated trade practice report, issued on September 25, 1987 and an audit trail report on this exchange, released on August 25, 1988; the New York Cotton Exchange trade practice and audit trail report, issued on July 8, 1988; the Coffee, Sugar and Cocoa Exchange trade practice report, released on September 19, 1986; and the New York Futures Exchange trade practice report, issued on July 25, 1986.

Each of these reports contains an assessment of the intensity of the execution of exchange compliance programs and recommendations directed to upgrading them. Commission staff currently is in the process of conducting rule enforcement reviews of NYFE, CSCE, Comex, and NYMEX. The Commission believes that continuous oversight, such as the rule enforcement reviews, is essential to assuring an appropriate level of intensity of exchange efforts and responsiveness to market developments and change.

The structural design and mechanisms used to effect an exchange's compliance program constitute its framework of controls, as defined by GAO. Commission staff in the Division of Trading and Markets assesses the sufficiency of these frameworks through rule enforcement reviews, which are public reports that provide evaluative guidance concerning exchange programs, and through direct surveillance.

During a rule enforcement review, Commission staff examines the design and execution of a number of compliance subprograms, including trade practice surveillance, market surveillance, disciplinary actions, and audit trail systems, and generally bases its analysis of the overall framework of controls on the capacity of those subprograms to achieve satisfactory compliance results. Rule enforcement reviews include suggestions for specific improvements in the methods and mechanisms employed to achieve compliance where existing systems of controls or programs are found wanting.

In addition to these specific improvements, in 1986 the Commission required all exchanges to adopt a much improved audit trail. The improved audit trail provides the Commission and exchange compliance officers with a more accurate record of trading. Separately, Commission staff have found that most exchange programs must be supported by adequate computerization for compliance efforts to be sufficiently prompt and efficient in the detection and sanctioning of violative activity. Since 1982, all programs that previously had depended primarily on manual review have been up-graded to provide for computerized surveillance. Since 1987, all exchanges have implemented one-minute audit trails. These mechanisms, implemented at the direction or the encouragement of the Commission, have improved the controls available at each exchange for achieving sufficiently intensive compliance efforts.

As stated in its most recent reviews, the Commission has found that each New York exchange generally has established a framework of controls that is adequate to allow performance of its self-regulatory functions. The Commission's assessment of an exchange's controls, however, is an ongoing process based upon the exchange's execution of its compliance programs and a variety of independent Commission oversight activities. Reports that assess the framework of controls are updated periodically, and the Division, through rule enforcement reviews, is currently reexamining the adequacy of controls used by CSCE, Comex, NYFE, and NYMEX.

Further, when new or disruptive market developments are indicated or occur, the Commission reexamines the sufficiency of existing exchange programs to address such occurrences. An exchange also is expected to reexamine the sufficiency of its programs, on its own initiative as part of its self-regulatory responsibilities, in response to disruptive occurrences. Examples of this review process are the efforts made by the Commission, in cooperation with other agencies, to encourage the exchanges to address Expiration Friday volatility in stock index contracts, the recommendations for the fine-tuning of financial surveillance programs made following the Volume Investors default, and the recent encouragement of the exchanges to form a Joint Compliance Committee to develop cooperative mechanisms for intensifying compliance at all exchanges. An example of an exchange's review of its own programs is the recent response of the CME to the publicity surrounding the Chicago FBI investigation.

One aspect of an exchange's system of controls is its procedures for identifying, investigating, prosecuting, and disciplining violative conduct. GAO specifically identified data on the number of actions undertaken by an exchange's disciplinary program as a factor in assessing the intensity of exchange efforts. Other criteria used by the Commission to evaluate disciplinary programs include the capacity to generate investigations independent of a complaint; the timeliness, quality, and scope of particular actions; the support for and documentation of particular findings; the adequacy of sanctions with respect to the violation found; and the sufficiency of measures taken to address recidivism.

The Division's 1987 rule enforcement review of Comex demonstrates the application of some of these criteria to an exchange disciplinary program. In that review, the Division found, among other things, that Comex had failed to conduct sufficiently timely hearings following the conclusion of its investigations. The Division recommended that the Exchange act expeditiously in these matters and requested copies of disciplinary logs and minutes on a monthly basis to monitor compliance with this recommendation. As a result of Commission oversight efforts, Comex considerably improved the timeliness of its disciplinary actions by, among other things, amending Exchange rules to establish deadlines for separate stages of the proceedings and by taking other steps to assure that such deadlines were met.

With respect to the factors identified by GAO for assessing such programs—specifically, the number of cases and type of penalties assessed—the data on New York exchanges generally demonstrate an increase in the number of disciplinary actions in the past few years and an increase in the size of fines imposed. For example, from 1987 to 1988, Comex doubled the number of members suspended for trade practice violations from 7 to 14 and, in 1988, collected fines for trade practice violations totaling $592,500 as compared to the 1987 total of $330,200. NYFE, over the same period, increased its fines for trade practice violations from $6,750 to $72,022 and dramatically increased the number of disciplinary actions taken for trade practice abuses from 8 in 1987 to 38 in 1988.

The New York exchanges' actions in response to Commission oversight results and the exchanges' actions on their own initiative have improved their systems of controls, enhanced their ability to identify trends of abuse, and increased the resources allocated to compliance programs. During reviews of the exchanges' programs and through other means, the Division has identified and exposed a number of program deficiencies. Ongoing review and other follow-up activities by the Commission assure that the exchanges rectify these deficiencies.

In addition to the examples mentioned above, the Division's 1988 special review of NYMEX demonstrates the use of Commission oversight powers and the use of exchange initiative to improve exchange control systems upon the receipt of new information. In 1988, NYMEX uncovered potentially improper activities by its Chairman of the Board and Director of Compliance which involved apparent conflicts of interest with exchange self-regulatory responsibilities and raised issues of possible nonindependence of the compliance program. The Exchange appointed a special committee to conduct an investigation into these events, and the Division evaluated the adequacy of this investigation. As a result of Division recommendations and through the Exchange's own initiative, NYMEX has implemented new rules in this area, replaced the former Chairman, who resigned after the Commission's report, dismissed the compliance director, and reported the director's activities to the appropriate professional association.

Commission staff oversight of the CSCE's program for monitoring cross-trades is an example of the identification of possible trends of abuse. Since cross trades involve the on-floor matching of two orders held by the same floor broker, the practice may be susceptible to abuse. It is necessary, therefore, for an exchange to monitor the execution of all such trades. Division review resulted in a finding that the Exchange had an inadequate program for the surveillance of cross trades. During its reviews, the Division also found that the CSCF had failed to sanction adequately brokers who had repeatedly violated exchange cross trade rules. The Division has made a number of recommendations in its rule enforcement reviews to improve the monitoring of and methods of recordkeeping for, such transactions and to increase sanctions for repeat offenders. The Division will assure that CSCE compliance efforts regarding such trades are consistent with the Commodity Exchange Act and applicable regulations.

Similarly, the Division's oversight of NYCE's market surveillance program revealed inadequacies in the Exchange's program. The Division was concerned about the sufficiency of the Exchange's procedures for, and its allocation of resources to, analyzing market data, maintaining records on market information, and conducting investigations into suspicious market activities. As a result of Commission oversight activities, the NYCE has enhanced its market surveillance program and responded favorably to all Division recommendations in this area.

Commission staff follow-up of Comex's difficulties with its system for clearing and matching trades during a period of market disruption in April and May 1987 resulted in the allocation of additional resources by that exchange to the improvement of its framework of controls. This action was based on Commission oversight and the Exchange's own initiative as to how best to address the problem. Comex experienced difficulties with its clearing and matching system, resulting in a large number of out-trades during periods of extremely high volume. As a result of ongoing discussions and critical input from the Division of Trading and Markets, the Exchange reallocated resources to automate and redesign its entire clearing and matching system.

In addition, the Commission used the results of its oversight reviews to recommend the allocation of resources by all New York Exchanges for the development of computer-assisted trade practice programs. Based on rule enforcement reviews, the Division found that the exchanges' ability to identify and conduct trade practice investigations could be enhanced by creating computer programs designed to isolate patterns of possible illegal trading activity for more efficient review. Recommendations by the Division of Trading and Markets in this area led to the implementation of computer-assisted surveillance systems. Each of the exchanges, on their own initiative and with Commission encouragement, continue to refine and improve such surveillance systems.

An additional instance of the exchanges' continuous endeavors to address trade practice problems and other matters is their commencement of internal reviews following public reporting of the ongoing undercover investigation in Chicago. In this connection, by letter dated February 8, the Division of Trading and Markets has provided each exchange with a list of specific issues to address.

These examples of exchange problems and solutions indicate that the New York exchanges' surveillance programs generally have improved over the years in response to self-regulatory and Commission oversight activities.

Q.2. In response to a question submitted to the Commission with Chairman Leahy's February 9 letter, the following statement was made by CFTC: "Effectiveness [of trade practice surveillance] is measured both in terms of the capability of systems in place and the results obtained through the use of such systems."

What standards or guidelines do you and the other Commission members use to measure the significance of the results of the exchange's efforts when evaluating exchange disciplinary records and surveillance and monitoring systems? That is, what objective standards do you apply to determine "effectiveness"?

A.2. The Commission uses primarily qualitative standards rather than quantitative standards when it assesses the effectiveness of an exchange program. Qualitative standards allow for a more thorough assessment of the overall efficacy of a program than does the mere counting of disciplinary actions or investigations. Although some specific quantitative results are considered in the evaluation of surveillance efforts, those are used to reflect overall qualitative performance, to compare the performance of an exchange over time, and to measure responsiveness to Commission recommendations.

Exchanges must adopt rules that provide for certain standards of conduct. Commission Regulations establish guidelines for the standards, among which Commission Regulation 155 requires exchanges to adopt rules that prohibit members from taking advantage of customers' orders, Commission Regulation 1.52 states that all exchanges and the National Futures Association must have minimum financial and related reporting rules in effect for their member futures commission merchants and introducing brokers, and Section 4f and 5a(12) of the Act and Commission Regulations 1.41, 1.62, and 3.11 provide that all exchanges must adopt rules to prevent any person from acting as a floor broker unless such person is so registered under the Act. Under Section 5a(8) of the Commodity Exchange Act and Commission Regulation 1.51(a), all exchanges are required to use due diligence in maintaining a continuing affirmative action program to enforce their rules and secure compliance with the provisions of the Commodity Exchange Act.

Commission Guideline Two establishes certain standards for meeting the requirements of Regulation 1.51(a). According to this Guideline, the requirement that an exchange use due diligence in maintaining its surveillance programs means that the exchange must use proper, sufficient, and reasonable care and effort in carrying out its procedures.

The degree and amount of care and effort which is considered proper is to be determined on a case-by-case basis. The Guideline also provides that, in order to maintain a continuing, affirmative program of rule enforcement, an exchange must have a suitable staff engaged in actively and continuously looking for possible violations, regardless of whether the exchange has received any customer complaints, referrals from the Commission, or other requests for investigation. In that connection, Commission Regulation 8.05 requires the compliance staff to be independent, and Commission Regulation 1.59 requires the staff to safeguard nonpublic information. Regulation 1.51(a) requires exchanges to establish certain subprograms within their rule enforcement programs. These subprograms include the surveillance of trading practices and market activity, examination of members' records, investigation of customer complaints, investigation of other alleged or apparent violations, and prompt and effective disciplinary action.

The Division monitors compliance with Section 5a(8), Regulation 1.51(a), and Guideline Two through its rule enforcement review program and through direct surveillance. Rule enforcement reviews generally include analysis of an exchange's market surveillance, trade practice surveillance, and disciplinary action programs. Following recent amendments to the audit trail regulation, the reviews also have included a more detailed and wide-ranging analysis of an exchange's audit trail system.

When reviewing an exchange's trade practice surveillance program, the Division's examination includes oversight of floor and record surveillance, customer complaints, and exchange investigations. An adequate exchange trade practice surveillance program generally includes surveillance of floor activities at the open, close, and randomly throughout the day; periodic review of trade registers for suspicious activities; complete reports of all investigations, including reasonable recommendations for further action; and thorough and timely investigations based on information obtained as a result of floor and record surveillance and on customer complaints and Commission referrals. Commission Regulation 8.06 states that investigations are to be completed within 4 months unless there exists significant reason to extend it beyond this period.

For market surveillance, the Division focuses generally upon large trader and deliverable supply information, as well as price relationships. Exchanges must have programs in place for effectively monitoring each of these areas and for recording observations made as a result of these programs. Furthermore, they must have the ability to react quickly and effectively to market situations. The actual reactions of an exchange to specific market situations which occurred during the target period of a review are assessed through Commission oversight as well as through direct review of such activities at the time that they occur.

For disciplinary programs, the Division considers, among other factors, the actual support for findings, the adequacy of sanctions, the efforts to address recidivism, and the timeliness and scope of actions. Commission Regulation 8.09 provides that disciplinary committees must promptly review investigations and, within a period of time not to exceed 30 days, determine whether charges should be issued or no further action should be taken; Commission Regulation 8.17 provides that hearings shall be promptly convened after reasonable notice; and Section 8c of the Act provides that all disciplinary decisions must be made public. The Division also considers the number of disciplinary actions and amount of fines as indications of the adequacy of an exchange's disciplinary programs.

During audit trail reviews, the Division analyzes an exchange's trade records, one-minute trade timing accuracy, and effective integration of one-minute trade execution times in exchange compliance programs. As part of these reviews, the Division examines order tickets, trading cards, and other trading documents to determine whether they contain all required information and have not been altered. In assessing accuracy of one-minute times, Commission staff considers whether these times are verifiable.

The Division's reviews also include consideration of such factors as exchange staffing, the appropriateness and efficacy of the parameters of programs used to identify violative conduct, the adequacy of documentation of the actions taken, and the exchange's implementation of prior Division recommendations. When the Division uncovers deficiencies in an exchange's program, it recommends improvement and monitors the response to its recommendations to determine whether further action is necessary.

The Division performs its own direct surveillance of the markets for trade practice abuses and refers certain matters to the exchanges and the Division of Enforcement for further investigation. Under this program, the Division can assess whether the responses of an exchange to record information obtained on trading are sufficient and whether an exchange is identifying sufficient activity for further review. This activity of the Division permits it to further evaluate the aggressiveness and quality of the exchange program.

The Division also assesses the responsiveness of exchange programs to market events and the capacity of these programs to address new information and to function effectively in the course of market disruptions. Self-regulators must review their programs from time to time and after specific events, such as defaults or unusual periods of market volatility, to assure that these programs are designed to achieve their objectives in all known circumstances. In this connection, the Commission will review the adequacy of any changes made to exchange programs to address activity considered in the ongoing Chicago investigation or otherwise identified by exchange or Commission enforcement programs.

Q.3. On page 9 of Chairman Gramm's prepared statement there is a table setting forth data on trade practice investigations for the 3 largest exchanges from 1986 through 1988 (CBOT—represented about 47.5 percent of the trading volume in 1988; CME about 26.7 percent; and NYMEX about 11.7 percent). The table gives rise to a couple of questions.

Q.3.(a). First, do you have any explanation for why the largest number of investigations in 1988 was initiated by the smallest of these three exchanges (130 by NYMEX compared to 128 by CME and 26 by CBOT)?

A.3.(a). The number of different types of investigations at a particular exchange is a product of several factors, including how an exchange categorizes and defines investigations, the systems it uses to identify conduct for further review, and how it allocates resources. For example, the Division customarily does not use a specific level of funding as a barometer of effectiveness but, rather, assesses whether the design and execution of exchange programs are adequate to deter and detect abusive trading practices. As a result, the performance of a small but qualified compliance staff at one exchange may be superior to that of a more costly but poorly-administered or less-expert compliance staff at another exchange.

The table from Chairman Gramm's prepared statement indicates that the Chicago Mercantile Exchange had a decrease in the number of internally-generated investigations from 1986 to 1988. During the time-frame of this decrease, the Exchange implemented significant improvements in its automated surveillance procedures, which resulted in greater precision in identifying patterns of trading that warrant further investigation and, consequently, the initiation of fewer unsuccessful investigations. The CME has developed the Computer Assisted Trade Surveillance System, which was substantially implemented by 1986. That system analyzes audit trail data to identify a number of possible trading abuses through computerized searches, using a series of specific trade practice reports.

In contrast, NYMEX just recently implemented a computerized trade surveillance system, and during the time period reflected in the table had relied primarily on manual reviews of trade registers. Although CME had 29 internally-generated investigations, as compared to NYMEX's 87, CME's investigations led to trade practice actions against 37 members, while NYMEX's investigations led to actions against only 8 members.

The table also shows that the Chicago Board of Trade ("CBT") had low numbers of internally-generated investigations for all 3 years. The Division cited the failure of CBT's trade practice surveillance program to generate investigations in its September 30, 1986 and February 17, 1989 rule enforcement reviews of the Exchange. Following the 1989 review, the Exchange set forth in detail a new program for conducting trade practice investigations. As a result of its review, the Division also recommended that the Exchange improve the timeliness of its inquiries and investigations and improve its records of trade practice investigations. In order for the Division to keep a close account of CBT's program, the Division has asked the Exchange to provide it with its logs of investigations on a monthly basis.

Q.3.(b). Is this type of data valid for purposes of evaluating the effectiveness of enforcement efforts of an exchange or comparing enforcement efforts between exchanges?

A.3.(b). With respect to GAO's data on exchange investigations, such information does not, by itself, demonstrate the relative adequacy of an exchange's trade practice surveillance program. The many differences among exchange programs limit the usefulness of comparisons among exchanges. The definition of the term "investigation," for example, can vary from exchange to exchange, and this variation must be considered when comparing statistics on the numbers of investigations.

Moreover, the manner in which an exchange conducts its investigations can be more significant than the number of investigations that it opens. If an exchange opens 300 investigations in one year but does not conduct these investigations in a satisfactory manner, then the number would not reflect accurately the effectiveness of that exchange's surveillance program.

The Division does consider data on the number of exchange investigations when it conducts its rule enforcement reviews; however, as noted earlier, these data generally are used to reflect overall exchange performance, to compare the performance of an exchange over time, and to measure responsiveness to Commission recommendations. As noted above, the Division considers a wide range of factors when evaluating the effectiveness of an exchange program, including the timeliness, scope, and adequacy of investigations.

Q.3.(c). Comparing the data for all 3 years, an unexpected difference is evident between the NY exchange and the two Chicago exchanges. Specifically, at NYMEX the majority of investigations appear to have been initiated from internal exchange data and staff expertise, but in Chicago the majority of the investigations are the result of external information such as complaints. How do you explain this difference and is it significant?

A.3.(c). As noted above in response to question 3(a), the number and type of investigations initiated by exchanges vary based on the exchanges' surveillance systems and methods of classification. Thus, although NYMEX had a greater number of internally-generated investigations, investigations at CME achieved more significant disciplinary results. The CBT, which has had a low number of internally-generated investigations, was directed by the Division to improve that aspect of its surveillance program.

When comparing data on exchange investigations other factors impact on the significance of relevant statistics. For example, investigations based upon complaints often are easier to develop than those based on the review of internal records. This difference can result from the specific information provided by the complainant and his availability to testify. Notably, an exchange cannot directly control the number of customer complaints which it receives. All of these factors must be weighed when evaluating the significance of data on the source and quantity of exchange investigations.

The CHAIRMAN. Thank you. Senator Heflin.

Senator HEFLIN. Let me ask you a little about dual trading. There has been a good deal in the press recently about it. As I understand in the Commodity Futures Trading Act of 1974, it directed the CFTC to determine whether dual trading would be allowed, and if the CFTC decided to permit dual trading, it was directed to set the terms and the conditions under which it was to be conducted. And the CFTC chose to permit dual trading. Now there has been a lot of questions about it. I would say how much of a problem is dual trading, and if the Congress would abandon it or if the CFTC would abandon it, would that eliminate the abuses that currently are being alleged as a part of the U.S. Attorney's investigation of the futures market?

Dr. **Gramm**. You are right, the Commodity Exchange Act of 1974 directed us to review dual trading from time to time, and we are doing so. As you know, there have been a lot of news reports that have addressed the issue of dual trading.

Although dual trading does have the benefit of providing liquidity in some of the markets where there is not a lot of volume, there is some concern about other incentives dual trading might provide. There might be some incentive there to violate the fiduciary responsibility that the dual trader has to his own customer. The Commission is currently reviewing dual trading again. We would like to get more information both from the exchanges and from our own internal review to determine the extent of dual trading, to determine what might be done, and under what conditions.

We have asked the exchanges to provide us with some more information as it relates to dual trading, and we asked them to do their own review of dual trading, and to indicate whether or not it ought to be limited across the board, in certain volatile time periods or in certain high volume pits or contracts. Also, I believe that as we get more information from the undercover investigation that information might illuminate even further the extent to which there might be a problem that could be corrected by, say, a limitation on dual trading.

Your question suggests an important point, whether dual trading should be limited to the same extent that it is on the securities side for the securities brokers. But for floor brokers on the security side on the exchange, there are some limitations on dual trading. But if we had that same kind of limitation in the commodities markets it would not necessarily eliminate the kinds of abuses that we are hearing discussed in the news reports about the undercover investigation. You could have some of these alleged violations, the violations reported to have occurred, even with securities style limitations on dual trading.

Senator **Heflin**. You probably covered some of this, but would you direct yourself, as you would view it, to the disadvantages of dual trading and the advantages of dual trading in such ideas as customer protection, market liquidity, the best price execution of the customer's orders, and the competitiveness of the U.S. futures market futures exchanges in the international market? Would you give us the advantages and the disadvantages of it for our evaluation?

Dr. **Gramm**. OK. Let me preface it by a comment that fiduciary responsibility is important and anytime you have an individual who is dealing with a customer's money, you have got a fiduciary responsibility issue. And you can have violations of that responsibility that occur in places other than a dual broker, for example, trading ahead of a customer. That is just for starters. The concern is raised that if you allow dual trading it may increase the possibility of a violation of fiduciary responsibility. That is one aspect.

Dual trading, however, does provide some liquidity in some contracts, in some periods, as well as in the out months in certain contracts where you do not have a lot of active trading. The ability of a broker to trade for himself as well as for a customer when the customer orders come in, provides liquidity to that pit, and some have argued that if limitations were applied there, it could reduce the liquidity of some very important pits, particularly in some of the ag or the lower volume contracts.

If you do not have liquidity in those markets, then customer orders would tend to dry up, and if these markets then lose their viability because they are not liquid markets, that is customers cannot come in and buy and sell when they want to, the markets will be less competitive. Not only would that market lose business to other potential competitors because of a lack of liquidity, but liquidity is important to generating other business as well.

Senator HEFLIN. It was about the competitiveness of the U.S. futures exchange in international markets. You may have touched on that.

Dr. GRAMM. I think the competitive issue applies to any other domestic or international exchange that might want to develop a competing contract.

Senator HEFLIN. The other one was about the best price execution of customers' orders.

Dr. GRAMM. I think on that one it goes both ways. The notion of liquidity is that a customer who places an order is able to buy and sell at what is close to the economic market price without having his order affect substantially the price at which it can be executed.

So in some sense, liquidity improves the ability to get a "more competitive or better price." On the other hand, people have concerns that if you have a dual broker there may be a greater chance that the broker will cheat the customer and not give him the best price. That the broker might have a greater ability to violate the fiduciary responsibilities that he has. So that one cuts a little bit both ways.

Senator HEFLIN. That is all.

The CHAIRMAN. Thank you very much. Senator Bond.

Senator BOND. Thank you, Mr. Chairman. It is a pleasure to welcome Dr. Gramm back. In the few months since we confirmed you, things have certainly gotten a lot more interesting in the exchanges. And your sense of timing taking on the job may not be the best, but we commend you for your efforts and what you have laid out today. Particularly, we commend the CFTC for participating in the aforementioned undercover operation. I realize you cannot talk much about it, but we will learn more about the work that you and your personnel did as these cases come to trial.

I think it is clear from what we have seen, there is no doubt that the system can be beaten. It has been. The questions are do we have adequate safeguards to detect the abuses? Are there adequate penalties; and are they being corrected? I really believe, in something like this, that fear, stark terror, is probably the best tool we have to prevent this abuse. We must ensure that people who do take a chance and violate the laws and the rules will be caught and will be punished.

To follow up on some of the general thrust of the questions the chairman asked, for my own enlightenment, when you have a rule enforcement review, and you lay out changes that are needed, do you have a system, a procedure, to follow up? You have mentioned some of the followups. What kind of regular process do you have to assure that the changes are made?

Dr. **Gramm**. When we do the report itself we have a final discussion with the exchange and discuss what our recommendations will be. Then we give them 60 days for a response generally. Generally, the exchanges have been very responsive and have told us before then that they will be responsive, but we wait 60 days for their official response. We also do followup reviews to monitor for the effectiveness of their responses.

I mentioned earlier that if we feel there is a need for it, we can require extra information from the exchange. We have done this with the Chicago Board of Trade. We have required them to report to us on a monthly basis so that we can monitor their progress more closely.

Senator **Bond**. And you have people in there who are not only getting the reports but who are checking physically to see what is represented in the report is actually being carried out?

Dr. **Gramm**. Yes. Basically, the purpose of this monthly report that we are doing with the Chicago Board of Trade is more hands-on monthly oversight in the areas in which we found them deficient.

Senator **Bond**. You mentioned the Minneapolis Grain Exchange. Are there any other instances where you have had to take disciplinary action because recommended changes have not been implemented?

Dr. **Gramm**. We have brought enforcement actions with respect to rule enforcement reviews of five exchanges.

The **Chairman**. Over what period?

Dr. **Gramm**. From 1977 on. No. I think I better——

Mr. **Klejna**. There have been several enforcement actions, as Senator Leahy noted earlier, against the exchanges. Some of them have been the result of rule enforcement reviews like, for example, the pending action against the Chicago Mercantile Exchange. Also, the Kansas City Board of Trade. And there have been other actions that have been the result of other activities. Only some are initiated through the rule enforcement review process, but the five exchange actions that Senator Leahy pointed out have all been, I think, within the last 5 years, and there were others before that.

Dr. **Gramm**. That was, by the way, Dennis Klejna, our Director of Division of Enforcement.

Senator **Bond**. Moving on to another area, I just received a copy of a recent Knight-Ridder news report that goes to the personnel that the exchanges use. According to this report, even though the floor committees are an exchange's first line of defense against trading improprieties, the CME does not prohibit or repeat rule violators from serving on its policing or disciplinary committees. Is this, in fact, accurate? Is this a problem that you ought to be concerned about?

[See pages 182 to 184 for the Knight-Ridder news report.]

Dr. **Gramm**. I am not sure. It depends on, I think, what the violations were and to what extent they might be a real problem in terms of the ability to serve on that board. One could also view those statistics in terms of the fact that they are not afraid of bringing cases against important members of the exchange. But again, it is something that I have just become aware of, and am looking into.

Senator **Bond**. I think we would be interested to have your further comments on this. It certainly does raise one's curiosity. In the GAO report, they mentioned the stark differences in the number of sanctions imposed at the CBOT and the Chicago Mercantile Exchange.

Apparently they have roughly the same compliance staffs. Are there just that many more problems at the CME or are they doing a better job of enforcement?

Dr. **Gramm**. Well, I think there, again, there are sometimes different ways to explain certain figures. We do look at the information about the number of investigations and sanctions brought, et cetera. However, sometimes it is a little difficult to say exactly whether or not those sanctions represent lax enforcement or the nonexistence of violations.

Obviously, when we do our rule enforcement reviews we look both at things like these numbers because they are one indicator, but we also look at how they run their programs and, specifically, their investigations. As I have often said, the fact that we might have a large number of people brought to the D.C. jail, does that mean that D.C. is safer or not safer?

Senator **Bond**. I think that is a bad analogy. I would recommend we not use that one. I think we ought not to get into that. Your level of CFTC staff has been virtually constant over the last few years. Yet the number of trades and contracts has increased significantly within these exchanges. Do you feel that the staff size is adequate? Are you going to be seeking additional enforcement personnel?

Dr. **Gramm**. We like to think of ourselves as a lean and mean agency. And we have become more efficient in our contract approval process, and, as Ms. Corcoran had mentioned earlier on, over the years we have also delegated or had some of our authority switched from the CFTC to the NFA, which has freed up resources.

One more point, we developed our budget for fiscal year 1990, last summer. Now, I think that we may find that we need more resources depending on the need to put more resources into further investigations and followup as a result of the FBI investigation.

I would point out, however, that we have not received this past year the full amount that we, the White House, and OMB, asked for in our budget appropriation. And when you are talking about something on the order of $1 million since we are a small agency, that is a significant chunk of money. So I would just make that point as well.

Senator **Bond**. Thank you, Dr. Gramm. Thank you, Mr. Chairman.

Senator **Conrad** [presiding]. The chairman has asked that we continue on the basis of the order in which Senators appeared, and so in keeping with that rule, we will go to Senator Kerrey of Nebraska.

Senator **Kerrey**. Madam Chair, on page 8 of your prepared testimony you indicate that from 1986 to 1988 the CFTC conducted approximately 100 investigations. Were any of those investigations done undercover?

Dr. **Gramm**. We do not do undercover investigations. We do not have the authority to do that.

Senator **Kerrey**. You do not have the authority to do undercover investigations?

Dr. **Gramm**. We do not have criminal investigative authority, and well, I should not say we do not have the authority to do undercover operations, but if you are thinking of undercover operations like the ones that we are hearing about in the newspaper that—my understanding is that is unique.

Senator **Kerrey**. Do you have the authority to do undercover operations?

Dr. **Gramm**. Not like the kind of undercover operations that we are reading about in the paper. Now I would say that we can, for example, do other kinds of monitoring, what I would call testing, for example, consensual monitoring, consensual taping of conversations, for example, where we monitor, for example, for sales practice abuse even though the other side does not know that it is being taped.

Senator **Kerrey**. I understand that your answer is none of the 100 investigations were undercover, and I understand your answer to be that you do not have the authority to do undercover investigations.

Mr. **Klejna**. Well, apart from our involvement over a period of time in the current undercover operation, the other answer is that I do not think there is anything in the Commodity Exchange Act that expressly prohibits the CFTC from engaging in an undercover operation.

Dr. **Gramm**. Except to the extent that our employees would be doing things——

Mr. **Klejna**. Except to the extent that traditionally it is a criminal kind of investigation, and obviously the CFTC is not a criminal investigatory authority and does not have any criminal law enforcement authority like, for example, the Securities and Exchange Commission. And undercover operations have historically been criminal law enforcement tools.

Senator **Kerrey**. So again your answer is no.

Dr. **Gramm**. Right.

Senator **Kerrey**. None of those 100 were undercover, and you believe that is a consequence of the CFTC not having the authority to do undercover operations?

Mr. **Klejna**. Well, it is not——

Dr. **Gramm**. It is not exactly authority. It is just that, again, if we had Commission employees engaging in the kind of undercover operation, for example, that you are reading about that we would have, perhaps we would have other problems.

Mr. **Klejna**. Yes. I do not know that an agency such as the CFTC is equipped frankly to engage in the kind of highly complex, sophisticated, long-term kind of things that are generally thought of as undercover.

Senator **Kerrey**. That is a much different rationale.

Dr. **Gramm**. Right.

Senator **Kerrey**. If you are saying to me that you do not do undercover operations because you are not equipped to do them, that is a much different rationale than saying you do not do undercover operations because you do not have the legal authority to do so. I am trying to ascertain which is correct.

Dr. **Gramm**. I would like to do a little research on that because if we were to undertake the kind of undercover operation that I think you are referring to as opposed to say what I often refer to as a testing which involves a certain amount of undercover-like activity then I believe that there may be some restrictions on our ability to do that with respect to what our employees can do or what the Commission can do.

Mr. **Klejna**. I think it may require a further legal, if you want a strictly legal, answer. But there are aspects of an undercover operation, for example, like wiretapping potentially used in that kind of a sophisticated criminal inquiry that a civil law enforcement authority such as ours does not have the authority to undertake.

Dr. **Gramm**. Does not have.

Mr. **Klejna**. So a strict answer to, do you have the authority to do an undercover operation is that it may not be a clear yes or no, but in terms of the practical way in which you would go about doing it, there may very well be legal impediments.

Dr. **Gramm**. Impediments are——

Senator **Kerrey**. Let me restate the question. The question really is not designed to look into the future so much as it is intended to discover why, of the 100 investigations, none of those were undercover. I heard you say initially that the authority is not present. Then I heard you say the problem rests with the agency's capabilities, not with its authority.

Dr. **Gramm**. Again, I would like to clarify that and have my legal General Counsel do a more careful legal analysis of that. The point is this: there is not anything in our act that says you cannot.

Senator **Kerrey**. I am looking for the basis for the management decision, because I assume as Chair you are in managerial control of the CFTC.

Dr. **Gramm**. Yes.

Senator **Kerrey**. I am really looking for a management analysis of it, not so much a legal analysis of it.

Dr. **Gramm**. A management analysis?

Senator **Kerrey**. A management analysis as to why none of the 100 investigations were undercover?

Dr. **Gramm**. OK. Wait a minute.

Mr. **Klejna**. I do not know all of the 100 that you are looking at, Senator.

Dr. **Gramm**. Wait a minute. OK.

Senator **Kerrey**. I am just looking at page 8. You said there were 100 investigations.

Ms. **Corcoran**. Can I answer?

Dr. **Gramm**. Yes, these are, page 8——

Senator **Kerrey**. Anybody that wants to can answer. Anybody who has the answer can respond.

Ms. **Corcoran**. Let me try to answer. These were Division of Trading and Markets trade practice investigations. These are not even full enforcement investigations. What these were that are listed on page 8 of the prepared statement is our records review and computerized surveillance, and surveillance that would be based on rumors that come off the floor that are preliminary to sending activity that looks suspicious but is not at that point fully investigated somewhere else for further investigation.

So I think these are a very particular type of investigation anyway. We are only talking about Trading and Markets 'trade practice investigations that are primarily directed to looking at exchange data bases or investigating complaints that come to us partially before they go somewhere else to be fully investigated. I mean there are several levels of investigation. If we referred something to an exchange, they would do something further. We could refer it to the Division of Enforcement. They could do something further. They could subsequently refer activity for criminal sanction.

Senator **Kerrey**. But the answer basically is no. No matter what kind of investigations they were, at what level of analysis they were, they were not undercover, and the CFTC does not do undercover operations for the purpose of investigating the floor, and that is in part because of the agency's lack of authority, and in part because of the absence of the personnel needed to do it. Is that accurate?

Dr. **Gramm**. Let me rephrase that. In investigations including Division of Enforcement investigations, the Commission has, as I said earlier, cooperated with other criminal and other law enforcement bodies, but in the past we have not undertaken our own undercover investigations because of certain legal limitations, even though to my knowledge there is nothing in the Commodity Exchange Act that explicitly says thou shall not undertake undercover investigations of the type that we are hearing about. And to answer the other point that you raise, that is from a management perspective, it is my view—and, I am a great believer in division of labor and specialization—that we have a good cooperative enforcement effort, and we have encouraged cooperation with other agencies. The undercover nature of the investigation that we are reading about that we have participated in is something that is a very innovative application of a particular investigative technique to a financial market. I think it shows a commitment by the agency and the Government to use all kinds of tools in a cooperative fashion that are available in order to root out fraud and abuse wherever they may occur including on the financial markets. So that is a new kind of investigation.

Senator **Kerrey**. Let me ask a question about a case where there was very obvious cooperation between the CFTC and the Department of Justice. That case involved a man by the name of Thompson Sanders. Are you familiar with that case?

Mr. **Klejna**. We testified in that case, yes.

Senator **Kerrey**. It seems to me that we have here in the committee right now the expectation that the FBI is going to produce at some point some indictments, and we are going to be privy to an analysis very quickly of an awful lot of information that we currently do not have. In the meantime, we are postponing any discussion at all of reauthorization of the CFTC until we get all of that. However, we do have, it seems to me, although I have not, honestly looked at all the details of the *Sanders* case, an interesting situation here because I have a very small part of a statement by Judge Marvin Aspen who commented at sentencing that the CBOT was a "virtual cesspool of corruption."

He reached this conclusion after observing approximately 18 months of testimony after Sanders was suspended by the CBOT in April of 1987. The investigation ran all the way until November of 1988. Now Sanders, as I understand it, obtained counterfeit documents to get on the floor, and had another group of people participating with him. They wore disguises and banked only the profits and then walked away from all the losses. That is generally what he did and he was able to do it for a short period of time before being suspended by the CBOT in April of 1987. The case was then turned over to the Justice Department.

The Justice Department then brought the investigation before Judge Aspen. The Judge sentenced him in November of 1988. I must parenthetically say I have a question that really does not need answering right now, but why did it take the CBOT almost 90 days after sentencing to impose a fine on him? On the 28th of February they finally fined him $1 million, but he was in jail by the time the fine was imposed. They concluded, finally, that that would be enough evidence apparently to fine him. The question that I have is have you read the full statement of Judge Aspen, and are there findings in his comments that would perhaps be of use to the committee members as we try to find out, before actually receiving the FBI's report on the current investigation, as to what sort of actions ought to be taken to improve the policing of activities on the floor?

Dr. **GRAMM**. I would say that we can make available to you what opinions we have, and I have heard of his comments, and read of his comments, with respect to that, and frankly there are two points I want to make. One is that to repeat a point that I think it is important to note that what we have here, in the undercover investigation, is the use of some very aggressive, innovative techniques for uncovering fraud and abuse that has, to my knowledge, not been done elsewhere, particularly in the financial market area. And that it is a project that we have participated in that frankly my view is that it is appropriate and correct, and we support the notion of using all these innovative tools in order to root out fraud and abuse.

And we will find out. The fact of the matter is that as we improve the systems, as we improve the audit trail, for example, develop new systems, impose new systems, get them in place, use the data, use innovative techniques, that we will improve and we will get more information to find out how we can make further improvements. We will find out to what extent there is a "cesspool of corruption."

Senator **KERREY**. Mine was a very long question. I appreciate the difficulty in pulling together exactly what it was I was saying. The question really was do you find in reading the full statement of Judge Aspen things that would be useful to the committee now, or is the one comment quoted in the newspapers pulled completely out of context and inflammatory?

Dr. **GRAMM**. I have not read that full opinion, but we will look it over and send you what we believe might be information that could be useful to you.

Senator **KERREY**. Thank you.

[The material was subsequently supplied and follows:]

JUDGE ASPEN'S STATEMENTS AT SANDERS' SENTENCING HEARING

QUESTION SUBMITTED BY SENATOR KERREY

Question. Do you find in reading the full statement of Judge Aspen things that would be useful to the committee now, or is this one comment that he [Judge Aspen] made [referring to the Chicago Board of Trade as a "cesspool of corruption"] pulled completely out of context and inflammatory?

Answer. Commission staff reviewed the Aspen decision and the transcripts and testimony in that case. In this connection, the following observations are relevant.

Judge Aspen's comments regarding the Chicago Board of Trade should be analyzed based on the particular factual case before him. The case involved a fraudulent trading scheme in 1986 in the Chicago Board of Trade's Treasury Bond futures contract in which two nonmembers of the Exchange, Daniel Dewey and Daniel Kolton, gained illegal entry to the trading floor for the purpose of allocating profitable trades to the account of an Exchange member, Thompson B. Sanders, and leaving unprofitable trades as "outtrades." An "outtrade" results when two sides to a trade do not match as to certain clearing criteria, such as the price or quantity, or when a side of a trade is not submitted to clearing. Dewey and Kolton gained access to the Exchange trading area by using floor jackets stolen by Sanders and counterfeit floor badges and wigs provided by a fourth defendant, David C. Pelleu—a nonmember of the Exchange.

The trading scheme generated total profits of over $200,000. According to the record, the subject trading involved several instances of off-floor alteration of trading records. Specifically, the court found that a "victim broker" was left with a $145,000 outtrade as a result of Sanders' destruction of the record of an unprofitable trade.

The evidence before Judge Aspen in this case was limited to the details of this particular trading scheme. The record thus did not provide the full context for judging trading practices on the Chicago Board of Trade in general.

The Chicago Board of Trade immediately commenced its own internal investigation upon being approached by a floor member who had been victimized by the defendants' scheme. After conducting considerable investigative work in an effort to identify the "members" who placed the order which resulted in the outtrade, the Exchange determined that the "members" were imposters wearing counterfeit badges and disguises and referred the matter to the FBI.

The Exchange promptly furnished the FBI with its files and provided, among other things, computer support respecting records of trading activity, and expert testimony at the trial on behalf of the prosecution. The exchange suspended its own investigation at the request of the FBI.

Based upon the findings of its own investigation, which recommenced following Sanders' indictment on July 5, 1988, the Chicago Board of Trade, on February 24, 1989, permanently expelled Sanders from membership, and permanently barred him from associating with any member or member firm at the Chicago Board of Trade. In addition, Sanders was fined a total of $1,125,000. Five other members involved in the scheme were fined between $5,000 and $50,000 each and had suspensions imposed ranging from 15 days to 10 years.

Although Commission staff has been critical of certain areas of the Chicago Board of Trade's compliance program, such as in the Division of Trading and Markets' latest rule enforcement review of the Exchange, dated February 17, 1989, the Chicago Board of Trade has made changes related to the *Sanders* case and has implemented and proposed more general measures relative to the Division of Trading and Markets' rule enforcement review report.

The Chicago Board of Trade's Board of Directors has approved the following improvements that should aid in preventing or detecting occurrences of this type of trading abuse. To date the Board of Trade has installed a $1,000,000 security system consisting of a turnstile with authorized keycards needed to enter the trading floor, and committed $1,000,000 to enhancing its automated trade timing system and compliance program. Further, it proposes to implement several other measures relevant to the abuses cited. For example, it proposes to require that members' trading cards be picked up by clearing firms throughout the trading day at one-hour intervals from the opening of each respective market; to establish "complete accountability" by members and clearing firms for all preprinted sequentially numbered trading cards on a daily basis; to require that all trading cards receive an Exchange-designated time stamp as they are taken from the Exchange floor; and to require that clearing firms submit trades to the Board of Trade Clearing Corporation within one hour after the relevant trading cards have been collected from members. Other changes of general applicability proposed by the Chicago Board of Trade in fulfillment of its general self-regulatory responsibilities are changing the "standard" time bracket increment from 30 minutes to 15 minutes, establishing periods of 5 minutes as the first and last time brackets for all contracts' respective trading sessions, and establishing a two-minute trading session at the end of each trading day for all of its markets.

As you know, the Commission's oversight program considers exchanges' systems and controls to assess how they are designed and implemented to limit trade practice abuses. The accuracy of source documents, which was an issue in the *Sanders* case, is an area which the Commission had addressed before the Aspen statement and subsequently. In this regard, since 1987, the Division of Trading and Markets has conducted rule enforcement reviews of nine exchanges' audit trail systems, representing over 95 percent of all trading activity. In those reviews, the Division specifically assessed the accuracy of a sample of audit trail source documents, such as order tickets and trading cards, and each exchange's program for assuring the accuracy of these records. In its reviews, the Division made specific recommendations, supported by the Commission, with regard to improving the accuracy of source documents and exchange programs to monitor this accuracy, and to assuring the accountability of all trading cards. Further, the Division recommended that exchanges increase the frequency of trading card pick-ups to decrease the time available for possible alteration of those records. Implementation of these recommendations should reduce the potential for trading schemes such as the defendants'.

Further, a current publicly acknowledged Justice Department/CFTC investigation is looking at certain allegedly violative activity at the Chicago Board of Trade. Therefore, to the extent that Judge Aspen's statements reflect potential activities of regulatory concern, the Commission, the U.S. Attorney and the Exchange itself are currently addressing or have previously addressed these concerns.

[The material that follows is in response to the question concerning the authority of the Commission to conduct undercover investigations.]

COMMODITY FUTURES TRADING COMMISSION,
WASHINGTON, DC, *March 7, 1989.*

The Honorable THOMAS A. DASCHLE,
Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, Washington, DC.

DEAR SENATOR DASCHLE: As you will recall, during my testimony before the Committee on March 9, 1989, you expressed interest in Senator Kerrey's question concerning the authority of the Commission to conduct undercover investigations. Please find enclosed a copy of the answer we have provided to the Committee in answer to this question. Please feel free to call me if you have any questions concerning this response.

Sincerely,

WENDY L. GRAMM,
Chairman.

Enclosure.

QUESTION SUBMITTED BY SENATOR KERREY

Question. Do you have authority to do undercover operations?

Answer. In general, the Commission has broad authority to investigate violations of the Commodity Exchange Act (CEA). The CEA does not distinguish between overt or covert (i.e., undercover) investigations. However, certain statutory provisions can bar CFTC employees from engaging in certain types of undercover activities. These legal obstacles are quite apart from more practical impediments, such as budgetary constraints, and the fact that many CFTC employees are too well known to be able to adopt another identity successfully.

A. AUTHORITY TO CONDUCT INVESTIGATIONS

The CEA authorizes the Commission to conduct investigations to determine whether there have been violations of the CEA or Commission regulations. Through delegation from the Commission, the Director of the Division of Enforcement and members of his staff may obtain evidence through voluntary statements and submissions, through exercise of inspection powers over boards of trade, reporting traders, and persons required by law to register with the Commission, or, when authorized by order of the Commission, through the issuance of subpoenas. Routine investigative techniques, which do not require explicit Commission approval, are used in virtually every investigation. The Commission also may authorize the use of compulsory process to subpoena the testimony of witnesses and the production of documents. Compulsory investigative techniques, which require Commission approval, are used in a significant number of investigations.

B. CEA AND OTHER STATUTORY RESTRICTIONS

The CEA and other statutes place constraints on the type of covert measures the CFTC may undertake.

1. *CEA Prohibitions Against Industry Employment and Trading.*—Some of the covert investigatory techniques to gather evidence of wrongdoing that have been recently reported in the press include purchasing exchange memberships, working as floor traders and trading futures. The CEA's conflict of interest provisions effectively prevent CFTC employees from utilizing these methods.

a. Section 2(a)(7) of the CEA prohibits any Commissioner or Commission employee from accepting "employment or compensation" from anyone subject to Commission regulation. It also prohibits direct or indirect participation in any contract market operations or transactions of a character subject to regulation by the Commission. Thus, CFTC personnel may not be employed by FCM's or exchanges. Nor would they be able to purchase an exchange seat, even assuming there were sufficient Commission funds to do so. In theory, it might be possible for CFTC personnel to "pose" as industry employees with the cooperation of the "employer." However, this would entail disclosing the undercover operation to third parties outside the government.

b. A second conflict of interest provision is Section 9(d) of the CEA, which makes it a felony for any member or employee of the Commission to participate in any commodity futures, option or leverage transaction. This is also expressed in the Commission's Code of Conduct, 17 C.F.R. § 140 .735-4(b). While Section 9(d) gives the Commission power to develop appropriate exceptions to these restrictions for transactions determined not to be contrary to the public interest or otherwise not inconsistent with the purposes of § 9(d), such exceptions must be made "by rule or regulation." Therefore, in order to permit a Commission employee to trade instruments regulated by the Commission, the Commission would have to undertake a rulemaking. Such a rulemaking, however, would not overcome the other statutory obstacles discussed below.

c. Further, CFTC employees are subject to the criminal conflict of interest provisions of Title 18, such as those requiring that governmental employees be paid only by the United States. Violation of these provisions is a felony which could not be waived by the Commission.

2. *Non-CEA Statutory Prohibitions.*

5 U.S.C. § 5946.—Prohibits the use of appropriated funds to pay membership fees of an employee of the United States in a society or association. (Memberships may be purchased in the agency's name if membership is a "necessary expense," but such disclosure would frustrate the covert nature of the operation.)

31 U.S.C. § 3302(b).—Requires that agencies receiving money from any source deposit the money in the Treasury as soon as practicable. Thus, if the Commission received any money from an ongoing trading operation, those funds would have to be deposited with the Treasury as soon as practicable. This would prohibit the use of income to offset the cost of conducting an operation. The FBI and the Drug Enforcement Administration ("DEA") receive exemptions from this provision in their appropriations for undercover operations.

31 U.S.C. § 1341.—Prohibits expending or obligating amounts in excess of an appropriation. The FBI and the DEA are exempted from this section for the purpose of carrying out undercover operations.

31 U.S.C. § 9102.—Prohibits the establishment or acquisition of a corporation unless specifically authorized by law. Again, FBI and DEA undercover operations are exempt from this provision.

41 U.S.C. §§ 254 and 255.—Set forth contract procurement procedures. Section 254 sets forth the requirements for granting government contracts, such as using other than sealed-bid procedures and the consequences and rights flowing from using such procedures. That section also provides for the submission of cost or pricing data by contractors and subcontractors. Section 255 provides for the payment of advance or partial payments under contracts from property or services made by the agency. Such payment can be made only upon adequate security and a determination by the agency head that such a payment would be in the public interest. FBI and DEA undercover operations are exempted from these provisions also.

3. *Electronic Surveillance Statute.*—Title III of the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. Section 2510 *et seq.*, commonly known as Title III,

permits "a person acting under color of law to intercept a wire, oral, or electronic communication, where such person is a party to the communication or one of the parties to the communication has given prior consent to such interception." 18 U.S.C. Section 2511(2)(c). The statute defines "intercept" as "the aural or other acquisition of the contents of any wire, electronic, or oral communication through the use of any electronic, mechanical, or other device." 18 U.S.C. Section 2510(4). Pursuant to this statute, the Commission in 1985 established procedures authorizing its employees to engage in consensual telephone monitoring for law enforcement purposes. As provided by Title III and Justice Department guidelines, these procedures permit Commission employees with special authorization to record only telephone conversations to which the employee is a party.

Title III also authorizes federal judges to issue orders for domestic wiretapping and electronic eavesdropping. It is far from certain that Commission employees could utilize these provisions of the statute to engage in undercover activities. Title III is administered by the Department of Justice which has the responsibility to initiate court approved interception of communications. We are aware of no instance in which a federal regulatory agency, such as the CFTC, has obtained a Title III court order.

Lastly there are other concerns, such as potential civil liability and immunity from criminal prosecution for criminal activity committed by Commission employees engaged in undercover operations which could preclude such activity.

Dr. GRAMM. I would like to reiterate a point. I have spoken to the Justice Department at all levels, and told them of your oversight responsibilities and your oversight authorities, and have impressed upon them that the extent to which they can make as much information available to you in your oversight capacity as possible about the investigation that I would appreciate that they would.

I am not sure how much they will be able to give you very frankly, because they do not want to jeopardize the ongoing nature of these cases, or to reveal, for example, sources and methods, et cetera. But I have made the request.

Senator CONRAD. Senator Gorton.

Senator GORTON. Thank you. First, Mr. Chairman, I was not here at the beginning of the hearing. I do have an opening statement. I would like unanimous consent that it be included in the committee record.

Senator CONRAD. Without objection.

[The prepared statement of Senator Gorton can be found on page 67.]

Senator GORTON. Mrs. Gramm, with the exception of one or two questions asked by Senator Heflin with respect to dual trading, this hearing has been, it seems to me, entirely and properly focused on enforcement activities; the Division of Enforcement responsibilities between the Commission and the various self-regulating bodies in these exchanges and the like. I would like to ask you if you are prepared to comment now or if you will be prepared to comment in the future on what seems to me to be the next logical set of questions beyond that. My fundamental question will be: Is there something in the nature of the futures or the securities, if one can call them that, being traded on any of these exchanges, or is there something in the nature of the professions of the people who work within them which is so seriously or so broadly capable of leading to conflicts of interest to self-dealing and the like that we should be looking carefully into that?

To put this question another way, no matter how good you get at enforcement, or how many computers you install, or how much enforcement activity you have, is there something fundamental in the nature of this business which lends itself and will lend itself in the future, as apparently it has in the past, to double-dealing or to illegal activities? Should we be viewing that subject as well as these precise enforcement techniques which have been the subject of this hearing?

Dr. **Gramm**. Senator Gorton, I think that is a good question. It is a very difficult question to address. Let me mention in deference to my Division of Trading and Markets, a lot of what we have been discussing today is oversight of trade practice surveillance which is used in conjunction with our enforcement program, in addition to the other parts of the Commission. If you would not call them securities, I would appreciate it.

The point that I have made before and I think is worth reiterating is that as a law enforcement agency we do the best we can with the tools we are given to ensure that these markets have the financial integrity as well as the customer protection that is contemplated in the Commodity Exchange Act. And I would say that over the years since the founding of this Commission that you would have events that have occurred that have allowed us to gather more information and to learn from the experience and also to improve our systems.

I think the undercover investigation may give us more information with respect to extent of violative activity on the floor of the exchange among brokers, for example. I think that one of the important byproducts of that investigation is to look at this particular activity to determine what more needs to be done.

And that is not something you typically see. I mean basically the question you ask is, has embodied in it, the question of is this industry or the participants in this industry, say, breaking rules of responsible fiduciary responsibility, for example, more often than, say, in another industry or even in other financial markets, for example, the securities industry. That is a very hard comparison to make overall because you need to get information that is difficult to obtain to be able to make those kinds of judgments. I think it is difficult to say at this point, but I do think that with the investigation we will get at least more information, not so much comparatively, but more information about what can be done to improve what we have here.

In our view these markets are efficient and they do have integrity, but we continue to learn, and the undercover investigation is an important part of the learning process—it will permit us to see further the extent to which there might be violative activities. What does that mean for customer protection? What more can be done? Even before the report comes out the self-regulators are looking at a whole panoply of issues, including things like higher fines, raising the fear level, ethical standards, et cetera.

But your broader question is, indeed, a difficult one to address with the information we have.

Senator **Gorton**. Well, that leaves me pretty much where I was when I started the question. I am perfectly willing to accept your testimony. I think it is highly accurate that the systems that you are now using are better than the systems used in the past. I have no doubt that those systems can continue to be improved, and that is one of your goals in the Commission itself. I believe that the functions which these exchanges or markets play are vitally important in agriculture and elsewhere, but in order to provide those vitally important functions there has to be consumer confidence that the people who utilize those markets are being dealt with fairly.

Dr. **GRAMM**. Yes. Right.

Senator **GORTON**. And it is clear from the nature of this and of other investigations that there is some reason for consumers to be apprehensive about whether or not they are being treated fairly. My concern here is not with whether or not you are doing the best possible job you can in improving your systems to deal with the markets or exchanges exactly as they are structured and constituted now. My concern is whether or not we do not need to change much more fundamental rules than the amount of bonds you have or anything else? And dual trading, as Senator Heflin indicated, is simply one of those things.

Now the other, the securities markets, have determined presumably that dual trading creates such a tremendous problem of a conflict of interest, overwhelmingly so, that no rule circumscribing it, that kind of practice, can possibly create the necessary degree of confidence. You have not, at this point, and I pick this as an example because it is the example which has been most utilized, but my concern is broader than simply dual trading.

Dr. **GRAMM**. Sure.

Senator **GORTON**. It is whether or not there is something even deeper in the system than just the procedures or just the symptoms themselves that may have to be changed rather than simply your computerization, or a few more people in your enforcement division or the like?

Dr. **GRAMM**. Yes. I think there are a couple of important points to make. We are cooperating in an investigation that is unlike anything anybody has been willing to do in terms of rooting out fraud and abuse in a financial market, and I think it is an appropriate thing to do—I think it is appropriate for the AG to focus on that. I would point out that in the securities markets that some activities occur that we would consider violations are not considered violations by specialists, for example.

Second, dual trading is allowed for over-the-counter trading. Again, I spend more time on the futures side, but I have looked at the issue of dual trading and where it occurs in the securities markets, and it is limited per day and per issue for the floor brokers, the brokers on the securities side, on the exchange floor but not over-the-counter. One more thing to point out—these markets have a fair amount of market integrity in them. And that one indicator—sometimes when you have a big case that is found or some large, well-publicized case, one can look across and say well, to what extent is this widespread? Is there greed overtaking, for example, Wall Street, as was suggested when the Boesky cases broke?

Many of the customers in the futures markets are very sophisticated, large players, and in some sense they provide a certain amount of policing themselves as well. If they really felt they were not getting very good responses they would leave and go elsewhere, go international, and so there is a certain amount of self-disciplining that goes on within the markets as well, that we believe works hand-in-glove with what the Commission does to make these markets better than anyplace else.

Senator **Gorton**. Well, of course, many of those principals are large and very sophisticated. They in turn represent the wheat ranchers in the States of my two colleagues across the table and my own State who are not particularly sophisticated.

Dr. **Gramm**. Absolutely.

Senator **Gorton**. But who provide the ultimate commodity which is being traded.

Dr. **Gramm**. Right.

Senator **Gorton**. Mr. Chairman, I guess I have gone about as far down this road as I am going to get in this particular hearing. I retain an interest in this subject and a very real interest in something beyond the subject back here and that is the relationship between the two governing Commissions, but that is a set of questions for another time. I see that our chairman is back. Thank you, Mr. Chairman.

The **Chairman**. Thank you, and thank you, Senator Conrad, and Senator Lugar. I had to step out because the Judiciary Committee needed a quorum to vote Dr. Bennett's confirmation out, which we did. This took both Senator Heflin and myself away, and I apologize. Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

First, just a comment. I want to reiterate what Senator Lugar had said earlier. I too am persuaded that it is very important that we have an analysis, a thorough analysis, of what is the downside of going to a fully electronic trading system. Pursuing Senator Gorton's line of questioning, it seems to me the answer is quite clear. Why does this happen? Because there is a lot of money there, and with the current systems it is possible to cheat and make a lot of money. And human nature being what it is, that is what we are left with.

And so I think you asked the fundamental question. And Senator Lugar started down that path, I think, with this whole question of electronic trading. There is no question that electronic trading would be one way of eliminating a lot of the opportunities for cheating. The question is what are the weaknesses, and I just encourage you to pursue that on a timely basis because I think it is going to be uppermost in many people's minds. My specific question is did you or the CFTC ask the FBI or the U.S. Attorney to conduct the investigation that is now being reported so widely?

Dr. **Gramm**. I am afraid, Senator, that how the investigation actually got started is not something that I can comment on. As a matter of fact, I know that is something that is of interest to you, and I have raised that issue with the U.S. Attorney, with the FBI, with Judge Sessions, as well as the AG's office. Their response is that there are two reasons why we cannot discuss this investigation. One is of relevance, and the other one is that some of that information is among the most carefully guarded information in regards to criminal investigations.

Senator **Conrad**. Well, it would seem to me there would be no reason not to disclose whether CFTC asked them to conduct the investigation. I cannot understand what jeopardy would be created by an answer to that question. I am not asking if——

Dr. **GRAMM**. Yes. I appreciate your concern, and I have raised that with them again many times, and I am an economist, not a lawyer, but that is one of the things that they are very concerned about protecting. And I will be happy to have you discuss that issue with them as well.

Senator **CONRAD**. Well, they have indicated in the letter on behalf of the Federal Bureau of Investigation and my office, I want to take this opportunity to again thank you for your support of the grand jury investigation of illegal floor trading practices. Could you tell us the nature of the participation by the CFTC?

Dr. **GRAMM**. I am afraid I cannot. Again, I have had several conversations with the Justice Department to impress upon them the committee's need for information.

Senator **CONRAD**. You understand——

Dr. **GRAMM**. And at the appropriate time if they could provide that.

Senator **CONRAD**. You understand the position it puts us in.

Dr. **GRAMM**. Oh, I understand, absolutely.

Senator **CONRAD**. As defenders of the CFTC's role.

Dr. **GRAMM**. Absolutely. Absolutely.

Senator **CONRAD**. Because many of us feel that the CFTC is the appropriate authority, and it puts us in a difficult position to defend among our colleagues when the heat comes down if we are not able to explain CFTC's role with some specificity. I must say that in this letter from the U.S. Attorney on the question of the nature of CFTC's participation, he says that he sought the assistance and expertise of your agency prior to undertaking the investigation.

Without the assistance and counsel of your agency, this investigation would not have been possible. It would seem to me that there is some indication in the letter on the nature of the participation by the CFTC. Could you tell us if that letter correctly characterizes the participation of the CFTC?

Dr. **GRAMM**. I would say that that letter came unsolicited from the U.S. Attorney's office. I am not going to quarrel with his characterization of it.

Senator **CONRAD**. All right. Let me go to a different subject. Let me go to the enforcement issue.

The **CHAIRMAN**. Senator Conrad, if you could just yield a moment?

Senator **CONRAD**. I would be happy to yield.

The **CHAIRMAN**. The point you make is an absolutely correct and appropriate one. During the course of these hearings, we will need to know how involved CFTC has been in the probe, whether the Justice Department has stepped in and really done the work for them, and so forth. I appreciate Mrs. Gramm's difficulty in responding to these points regarding ongoing investigations.

Senator Lugar and I have written to Attorney General Thornburgh and asked him if at some appropriate time he could prepare a briefing about what is going on in this investigation, at the very least on a Senators' only basis. I agree absolutely with the Senator from North Dakota, that without a full understanding of the extent of the investigation, what led to it, and how pervasive they think this matter is—not so much who the individuals involved might be—it will be very difficult for us to do the kinds of oversight hearings needed here. I will continue to pursue this with the Attorney General. As I said, I could care less about knowing the names of individuals when they are targeting or anything like that. That is an investigative matter and they should keep it to themselves.

But I do want to know four things about the probe: one, the extent; two, what prompted it; three, how pervasive they think the problem is; and four, whether the Justice Department has found areas in their own investigation where we, the committee, or you, the CFTC, should be tougher in oversight.

I appreciate the courtesy of Senator Conrad in yielding to me.

Dr. GRAMM. May I also add to that that I have raised just the questions that Senator Leahy has raised. I have already spoken to the Justice Department about those questions, and your oversight responsibility. I would point out that they have given a special dispensation to release to the public the fact that we have been involved in the investigation from the beginning, and that is something that is very unusual because, typically, law enforcement agencies do not reveal even the existence of an ongoing investigation.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. I have one final question, Mr. Chairman, and I hope to make it brief. As I look across the Chicago Board of Trade, Chicago Merc, and NYMEX at contracts traded in 1988 and at internally initiated investigations from 1986 to 1988 here is what I see: Contracts, Chicago Board of Trade, 1988, 26 million; internally initiated investigations from 1986 to 1988, 16. Chicago Merc, 12.3 million contracts; internally initiated investigations, 137. At NYMEX, contracts 5.6 million; internally initiated investigations 242. It strikes me that that could tell us one of two things. Either that Chicago Board of Trade has better enforcement or better people and therefore fewer violations or that the Chicago Board of Trade has lax enforcement relative to the other exchanges.

Could you tell me how you would read those numbers, and if the answer is that one exchange is being lax, what is being done to correct that?

Dr. GRAMM. You raised the point that I made earlier that sometimes it is hard to tell from the numbers themselves. When we do our rule enforcement reviews, we look deeply into the exchange's programs and how they perform their compliance function. With respect to the Chicago Board of Trade and our recent rule enforcement review, we did feel that the one area where they needed to improve was in developing their own internal, generating their own internal, that is internal to their data systems basically, investigations of potential trade practice abuses. We felt that the system that they had did not generate sufficient numbers of investigations to do the kind of surveillance we felt was needed or was possible, given the new systems and new data available through the enhanced audit trail.

We have made recommendations in that area. They have told us that they will commit resources and personnel to doing a better job in that area. We will be overseeing them on a more hands-on basis monthly until we feel that the system, that their systems and their procedures are such that they basically are more effective in this particular area.

Senator CONRAD. Maybe just a final observation, Mr. Chairman. The Minneapolis Grain Exchange from 1986 to 1988, zero, zero enforcement activity, zero investigations, zero fines. I know that CFTC has taken action, and I think that is a very healthy sign where you have an exchange that is apparently doing nothing, or as close to nothing as could be. It is clearly a time for the CFTC to step in and I am pleased to say you have done so.

Dr. GRAMM. Yes, thank you.

The CHAIRMAN. Thank you very much. Senator McConnell.

Senator MCCONNELL. Thank you, Mr. Chairman. Mr. Chairman, I have an opening statement which I would like to have inserted into the record.

The CHAIRMAN. Without objection it will be placed in the record.

[The prepared statement of Senator McConnell can be found on pages 66 to 67.]

Senator MCCONNELL. Most of the questions I had have already been asked, but I thought, Dr. Gramm, I might ask you in looking at the changes that you might make in your systems, has your organization looked at the foreign futures exchanges to see what procedures they may be employing?

Dr. GRAMM. There are many foreign markets that are developing their own systems and futures and options markets; especially, financial futures. We have international expertise throughout the Commission and, particularly, in the Division of Trading and Markets.

Senator MCCONNELL. Are you looking at those exchanges? I understand the major ones are in London, Winnipeg, Sydney, and Hong Kong?

Dr. GRAMM. Absolutely. We are looking at them in great detail. We have developed cooperative relationships with them and we are reviewing not only their systems but all of their regulatory structures as well.

Senator MCCONNELL. Tell me a little bit, if you know, about what you are finding? Have they been having some of the problems that we have had in this country?

Dr. GRAMM. We do not know all about the kind of investigations they conduct, but I do not think there has been an investigation, or the kind of investigation and activity that is done elsewhere like we do here, and especially something like the undercover investigation as well.

Ms. CORCORAN. Well, first of all the off-shore exchanges do not have the same rules that we have with respect to what are prohibited trade practices, but furthermore what we are doing with respect to foreign markets at the moment is we are primarily looking at the rules that they have in place for purposes of, for example, permitting the sale of foreign option products to U.S. customers. We have looked to see whether they have compliance mechanism. We are really not in a position to evaluate their compliance mechanisms. What the Commission has done in lieu of that, and which is something that is being done in the financial markets generally, is attempt to develop very strong information sharing arrangements with the governments and the exchanges themselves to assure that we have sufficient information about what is happening in these markets to protect U.S. customers who participate in them.

Senator McCONNELL. But the rules of the game are substantially different in each of those countries?

Ms. CORCORAN. Yes.

Dr. GRAMM. Oh, yes.

Senator McCONNELL. So there may be limited use of their procedures to be applied to your——

Dr. GRAMM. Right. For example, some of their systems are different systems than ours. Some of them have computerized systems, for example, and some of the practices, well the practices that are being investigated, a lot of the regulations that we have have to do with the open outcry system that is prevalent in our exchanges.

Senator McCONNELL. Just one other very general question, Dr. Gramm. What in your view is the projected growth that we are going to see in the futures industry and how do you see the CFTC adapting to those changes?

Dr. GRAMM. Well, I think, if I could see the future maybe I would be rich and would not be working. But what I see is an awful lot of change and innovation. I see a lot of international competition as well. So growth implies something about U.S. markets being able to preserve a competitive position vis-a-vis all the competition that is coming from all over the world.

There could be substantial growth if the domestic exchanges keep their innovative edge and develop products that people want to buy and assuming that people also want to trade on those markets. But there are a lot of "if's."

Senator McCONNELL. And I assume that obviously how we handle this crisis has a great deal to do with whether we are competitive in the future?

Dr. GRAMM. Always. Always. Again, I would say the same thing after the market events of 1987, the market crash, that we learned something from that, and the markets are stronger from what we have learned and the improvements we have made. But obviously, if we impose changes that are noneconomic or do not get rid of the widespread problem, then that could have an effect, too. Customers can change.

Senator McCONNELL. The market could go elsewhere, could it not?

Dr. GRAMM. The markets could go elsewhere very quickly.

Senator McCONNELL. Thank you, Mr. Chairman. Thank you, Dr. Gramm.

The CHAIRMAN. Thank you very much. And I also want to thank Senator Daschle, who has been here throughout all this hearing and who agreed to backstop me as I had to go in and out on another matter. Tom, I really appreciate your doing that. When you are finished, I am going to have a couple wrap-up questions, but please feel free to take as long as you want. And again, I appreciate your coming in and stepping in as you have so many other times for me. It means a lot to me.

Senator DASCHLE. Thank you, Mr. Chairman. I learned a good deal this morning. I appreciate the opportunity to hear the answers to many of the excellent questions that were asked already this morning. I think that a hearing like this is critical for a lot of reasons, certainly for our own education but as well to provide a forum within which many of these public policy questions can be further debated later on.

Just for my own further education with regard to your answer to Senator Kerrey's question pertaining to undercover investigations and your authority, do I understand your answer to Senator Kerrey, Dr. Gramm, was that you are not entirely clear as to whether you have authority to pursue underground investigations, and that you would provide a formal response to that question at a later time?

Dr. GRAMM. That is right. For example, if the Commission were to undertake the kind of undercover investigation that would involve, for example, spending money and buying seats on the exchange and becoming members, having staff become members, et cetera, there are certain legal and budgetary implications that might come in conflict there. To my knowledge, however, there is nothing that says we cannot do it. But there are other factors that would come into play.

Senator DASCHLE. I will be very honest. I am not as concerned about your inability to answer the question with regard to specific authority as I am about the concern that I expressed to you yesterday. Once again, the perception that you create in that lack of ability in providing the answer.

We are talking here about some very serious questions regarding whether or not, as you provided in one of your answers, you do the best you can given "the tools." It would seem to me that along the way the CFTC would have asked themselves do we have the authority to conduct underground investigations? What is the reach of authority that we have to ferret out whatever difficulties, legal or ethical, there may be?

It seems to me that what you have told us is that discussion has never occurred. And that were it not for the fact that the FBI is conducting their own, perhaps never would have occurred. The issue before us is not just a question of whether you have the tools. It seems to me the question is how well you are using the tools, how well you are perceived to be using the tools.

You have listed very well the tools in your statement. The problem I have as I read through this and as I talk to you is that we have no measure by which we can judge whether those tools are, indeed, being used effectively. I can look at charts. I can compare, if I wish, your record to the SEC, which I suppose we should do to a certain extent, but perhaps you can tell me more persuasively than what has been represented in the document how do you judge, how do you measure your success in implementing these tools?

Dr. GRAMM. Let me first say that the issue that we might have discussed about our ability to do undercover investigations is one that I think is from my perspective not a relevant issue. I am a great believer in the fact that government agencies ought to coordinate and cooperate. We recognize that we do not have every kind of authority, and the fact of the matter is we have a Federal Bureau of Investigation whose job is to conduct certain kinds of investigations and that to me as a manager, it is appropriate to look to the FBI for that kind of authority, or to a U.S. Attorney for criminal authority.

We have coordinated and promoted cooperation with State and local officials and other Federal law enforcement authorities in order to, you might say, expand the reach of Government at all levels in rooting out fraud and abuse as it relates to commodities.

Senator **Daschle**. That is a matter of opinion, I suppose.

Dr. **Gramm**. I suppose it is a matter of opinion, but from a manager——

Senator **Daschle**. To say that it is not a relevant issue takes it quite a ways farther than I thought you would even take it. I mean the fact is that it is very relevant, or the FBI would not be discussed as frequently as they were this morning. It certainly has to be relevant as a measure by which we are effectively ensuring proper regulation of the industry. It has to be relevant in terms of another tool. You say we do the best we can given the tools. This is a tool. It is relevant in determining whether or not you ought to have that tool. So it is relevant in a number of very specific ways. I am surprised to hear you say that it is not relevant.

Dr. **Gramm**. No. The issue in my mind, and again I have discussed the issue because people have raised the issue and asked the question—would you want to have explicit undercover investigative authority in order to do the kind of undercover investigation that the FBI has done? My answer has always been that coordination and cooperation appears to be working and appears to be providing useful information including information which may well root out fraud and abuse, which is the objective of the Commodity Exchange Act and the objective of the Commission as well.

Senator **Daschle**. Let us go, if we can, in the short time that we have to as concise an answer as you can supply with regard to how do you measure your success in regulating the trade abuses that are so clearly represented?

Dr. **Gramm**. I think that how we measure our success is based on a lot of issues. One is the fact that we have markets that have performed well.

Senator **Daschle**. So number one is—I mean you are using some—I am hoping that you can provide me with the objective criteria that you use to measure the success of your responsibility as an oversight agency. The first is evidence of market?

Dr. **Gramm**. In terms of measuring our success, I believe there are two areas to assess. One is the area as I have provided to you all that we do, I agree that it is somewhat process oriented. But we do quite a bit in terms of oversight, public rule enforcement reviews, our own oversight programs, and the second is what these programs have produced over time.

Senator **Daschle**. But that is the process again. That does not tell me anything.

Dr. **Gramm**. And what they produce.

Senator **Daschle**. And that is a tool. Oversight is the tool.

Dr. **Gramm**. That is right. That is right.

Senator **Daschle**. How do you measure whether that tool is working?

Dr. **Gramm**. There are several things. One is you look at the process and procedures and what we have done, what our output has been in terms of the reports, in terms of the investigations, and what we have produced in terms of bringing actions.

Senator **Daschle**. But you said numbers are not a very good criteria by which to judge.

Dr. **Gramm**. I did not say that they are not necessarily good criteria. I have stressed several times that you have to look at what the numbers say, but there are alternative hypotheses as to what those numbers can mean, and that is why when we look at the exchanges, for example, to evaluate their oversight, we look not only at numbers, but we also look at underlying data and procedures as well.

In other words, you do look at output, you do look at numbers, you do look at procedures, you do look at the kinds of cases that have been brought, the kinds of investigations we have brought. You have to add all of these things together. It is the same as if somebody is reviewing us and when I look at our record, I have to look again at what we do in terms of procedures that we have, the investigations that we take. We do look at numbers, though again numbers do not tell the whole story. Neither do procedures. You have to look at it as a package.

Senator **Daschle**. You seem to be talking in a circle here, and what I would like, what I would like is no circle answer. What I would like, and you do not have to give it to me right now—it appears that you cannot give me a definitive, objective criteria by which you measure the success of your investigative work and your regulatory work, but I do think it is important. And I do not mean to be confrontational here. I think that it is, again, one of perception as well as it one of substance.

We have to know that you have definitive criteria by which to judge whether or not you are a success, and you have measured that criteria against your record, and on the basis of that measurement can give us a much better analysis than I get with this circulatory answers about performance. I do not have that today.

And I want to move on to one other thing, but I would like that for the record and in a specific response to me in a letter. Let me move on to the second question because we could go on here at some length. Is it a criminal abuse or is it an ethical abuse to participate in bucketing?

Dr. **Gramm**. It is against the law in——

Senator **Daschle**. It is against the law.

Dr. **Gramm**. Under the Commodity Exchange Act.

Senator **Daschle**. How about wash trading?

Dr. **Gramm**. Wash trading is also mentioned in the Commodity Exchange Act.

Senator **Daschle**. Is that against the law?

Dr. **Gramm**. In the Commodity Exchange Act, yes.

Senator **Daschle**. What about kerb trading?

Dr. **Gramm**. Kerb trading is mentioned in the law as well.

Senator **Daschle**. Cuffing?

Dr. **Gramm**. Cuffing, I do not remember a reference to cuffing in the law.

Senator **Daschle**. In other words, there are very specific abuses that are not only unethical but are illegal?

Dr. **Gramm**. Yes, and some of them are illegal according to the statute and some are illegal under our regulations.

Senator **Daschle**. OK. According to statute. What I am troubled by is again one of perception as well as substance. What do you do when you find someone who has been accused of bucketing?

Dr. **Gramm**. There are a number of things that we can do. If, for example, someone complains that someone has bucketed a trade and brings it to the attention of the agency, agency staff can open an investigation and check the allegation.

Senator **Daschle**. But you told us just a moment ago that you have no criminal investigative authority. Is that not what you told us? Maybe I misunderstood your answer.

Dr. **Gramm**. Sure.

Senator **Daschle**. You have no criminal investigative authority; correct?

Dr. **Gramm**. We have civil.

Mr. **Klejna**. We have civil investigations.

Senator **Daschle**. Yes, but you just told me that bucketing was specifically against the law.

Mr. **Klejna**. That is right.

Dr. **Gramm**. That is right. It is against our Commodity Exchange Act. That is right.

Mr. **Klejna**. We enforce the act through civil proceedings.

Dr. **Gramm**. That is right.

Mr. **Klejna**. But the U.S. Attorney or the Justice Department can enforce parts of the act through criminal actions. We do not have criminal authority.

Senator **Daschle**. But the SEC has criminal investigative authority; do they not?

Mr. **Klejna**. No, they do not.

Senator **Daschle**. They do not?

Mr. **Klejna**. No, sir.

Dr. **Gramm**. I do not believe so.

Senator **Daschle**. So in this regard, both the SEC and the CFTC handles specific criminal incidences in the same way. You uncover in whatever manner an abuse which is clearly illegal. You then conduct it in a civil proceeding.

Dr. **Gramm**. There can be several ways that we can do it. For example, sometimes we will initiate a civil proceeding. We may refer it to the criminal authorities who can bring criminal sanctions against some of our respondents. Sometimes we act at the same time. Again, cases can occur in several ways. From my understanding of law enforcement agencies, including the Federal Trade Commission and the SEC, et cetera, typically they bring administrative, that is civil cases, and then work with the Justice Department.

Senator **Daschle**. You bring civil cases.

Dr. **Gramm**. That is right.

Senator **Daschle**. Well, that is the first part of my answer to the first part of my question, and I appreciate the answer. That clarifies it. The second part of it deals with resources. Again, you say we do the best we can given the tools we have. Whether or not you are equipped depends in part on resources. What percent of the entire CFTC staff allocation is available for the investigative process in this regard?

Dr. **GRAMM**. Our Division of Enforcement investigates a number of cases, but we also have investigations that occur elsewhere in the Commission.

Senator **DASCHLE**. Well, can you not just tell me what percent?

Dr. **GRAMM**. Well, what kind of investigative? Are you talking about our Division of Enforcement?

Senator **DASCHLE**. The ones we are talking about. We are talking about bucketing. We are talking about——

Dr. **GRAMM**. OK. Are you talking about trade practice?

Senator **DASCHLE**. Trade practices, correct.

Dr. **GRAMM**. OK. Because I would say that not all of the Division of Enforcement's cases involve trade practice cases. They do sales fraud and other kinds of fraud, bucket shops.

Senator **DASCHLE**. Maybe I am misreading it. Do I understand your figures to read that you have approximately 16, perhaps 17, attorneys that handle trade practice investigations?

Dr. **GRAMM**. Probably that——

Mr. **KLEJNA**. There are not specific attorneys specifically assigned.

Senator **DASCHLE**. No, I realize that.

Mr. **KLEJNA**. There are various attorneys and you do all different kinds of cases.

Senator **DASCHLE**. That is right.

Mr. **KLEJNA**. I think the numbers are that about 15 or 16 percent roughly fluctuating, I think, in the information that you have.

Dr. **GRAMM**. Is that in the Division of Enforcement? Well, what about——

Mr. **KLEJNA**. Yes, only within the Division of Enforcement is there about 15 to 18 percent of our resources committed to these kind of investigations. But that does not include the Trading and Market staff.

Dr. **GRAMM**. Trading and Market is what? Over 30?

Ms. **CORCORAN**. 30—in actual staff—yes.

Dr. **GRAMM**. There are 30 involved in trade practice investigation.

Senator **DASCHLE**. You have 30 in trade practice and 15 or 16?

Dr. **GRAMM**. Yes.

Senator **DASCHLE**. But 30 is the total?

Mr. **KLEJNA**. Approximately 15 or 16 percent of 140, so whatever that would come out to in the Enforcement Division.

Senator **DASCHLE**. Well, to be honest with you, whether it is 30 percent or 15 or 16, you are talking about just one an exchange. I mean that is what it really comes down to. Maybe I am just not reading your numbers right, but it does not seem to me to be a very significant number of attorneys to handle the major responsibility you have in this regard. And I would also like a clarification, if I could, in that.

I am not at a point where I can come to any conclusions, but it certainly does not seem to me that—once again I am talking here about your success, how one measures success. You said a moment ago it is the allocation of resources.

Dr. **GRAMM**. That is part of it.

Senator **DASCHLE**. That is part of it.

Dr. **GRAMM**. That is a procedural thing.

Senator **Daschle**. That is right.

Dr. **Gramm**. That is the procedural aspect. You can look at that.

Senator **Daschle**. But I want to see the allocation of resources given your broad-based responsibilities and come to some conclusions with regard to whether or not those resources appear to be adequate. I must tell you, as I said, I do not think they appear to be, but you may be able to share some light on this that I do not have in front of me this morning.

Dr. **Gramm**. We would be happy to provide you with the information. It is sometimes very difficult to break out the exact number of resources on these cases. For example, if we have a number of cases——

Senator **Daschle**. Well, you can describe that.

Dr. **Gramm**. That is right.

Senator **Daschle**. But I think it is important that—I mean you have what—what did you say 140?

Mr. **Klejna**. Roughly.

Senator **Daschle**. Roughly 140 to cover all your responsibilities. And I have just got to see how you break that out before I come to any final conclusion.

Dr. **Gramm**. Sure.

Senator **Daschle**. But if you could provide that it would be very helpful as well as, I said a moment ago, a very specific determination as to how you measure success. Thank you, Mr. Chairman.

[The material was subsequently supplied for the record and follows:]

Questions Submitted by Senator Daschle

Questions. How do you assess the effectiveness of your oversight programs? What objective criteria do you use to measure the CFTC's success in carrying out its responsibilities as an oversight agency?

Answer. We assess the effectiveness of our oversight programs based upon their capacity to achieve market integrity and customer protection effectively. Although no single litmus test can be applied to measure the CFTC's success in achieving broad objectives of this nature, we believe that the effectiveness of the CFTC's oversight programs can be assessed based upon several qualitative measures. These measures, which reflect the several objectives of regulatory oversight, include:

—The ability of the CFTC to enhance its regulatory framework over time in response to changing compliance needs and rapid growth and innovation in the marketplace;

—The extent to which exchange self-regulatory programs have improved under the impetus of CFTC oversight;

—The capacity of futures markets safeguards to weather market strains and disruptions;

—The degree of public confidence in the futures markets, as manifested in trading volume and incidence of customer complaints; and

—Evaluations of the Commission's regulatory efforts by outside parties.

Each of these measures is discussed below.

1. *Enhancement of Regulatory Framework*.—An effective regulatory framework requires continual refinement to fill regulatory gaps which develop over time; to clarify regulatory responsibilities; to address new products, market participants, and problem areas; and to assure effective resource allocation. Consequently, a major test of the Commission's effectiveness in overseeing the futures markets is the extent to which it has made improvements in its oversight programs over time and adapted its regulatory programs to changing market conditions. In the period since the Commission's establishment in 1974, the futures marketplace has undergone dramatic growth in terms of volume and variety of products traded. For example, between 1974 and 1988, annual volume increased from approximately 28 million contracts to 295 million contracts and the number of active contracts trading increased from 32 to 116. There also have been changes in the trading systems em-

ployed and the kinds of market participants, for example, greater participation by institutional and foreign investors.

The Commission has developed and refined its regulatory framework to respond to these marketplace developments, to address incipient problems and to anticipate future developments. Regulatory enhancements made by the Commission since 1982 include:

(1) *Improved Oversight of Exchange Self-Regulatory Programs.*

—*Stricter and More Comprehensive Requirements for Exchange Self-Regulatory Programs.* Since 1982, the Commission has adopted significantly stricter exchange audit trail requirements, promulgated regulations requiring the exchanges to adopt rules in specified areas, and fostered other systematic improvements in exchange self-regulatory programs. The Commission adopted amendments to Commission Regulation 1.35 in 1986 requiring that the minute of execution be obtained for each trade. By 1987, all futures exchanges had implemented audit trail systems intended to meet that standard. Such systems are far superior to systems previously in effect, which used 30-minute bracket data, and continue to improve in terms of accuracy and integration of data in compliance programs. These changes also address the increased volume of trading by rendering surveillance more efficient.

New rule requirements include Rule 1.61 (requiring exchanges to adopt speculative position limits), Rule 1.62 (requiring exchanges to adopt and enforce rules providing that no person on the floor of an exchange may trade for another unless duly registered as a floor broker with the Commission); and Rule 1.59 (requiring exchanges to maintain rules prohibiting employees from trading in contracts as to which they have access to material nonpublic information and prohibiting disclosure of such information). These changes address the development of new contracts and the need to assure that exchanges take responsibility in the first instance for compliance.

The Commission has also published amended standards for exchange oversight of their member compliance with minimum financial, segregation and related requirements (Financial and Segregation Interpretation 4-1) and minimum acceptable standards for sales practice audits conducted by the National Futures Association and the exchanges (Sales Practice Audit Interpretation No. 1).

—*Improved Trade Practice Surveillance.* Since 1983, the Commission has improved its trade practice surveillance oversight program by increasing the frequency of trade practice rule enforcement reviews and by modifying the content of rule enforcement review reports from largely descriptive reports on program design to qualitative and quantitative analysis of the effectiveness of exchanges' execution of their programs. Over the past 5 years, the Division of Trading and Markets has completed 34 trade practice rule enforcement reviews, representing a 64 percent increase over the previous timeframe. Reviews have been refined to include focused or "limited-scope" reviews of particular aspects of an exchange's program, such as audit trail systems, and follow-up reviews, which focus on implementation of remedies addressing inadequacies identified in previous reviews. The greater frequency, increased focus and more substantive content of rule enforcement reviews has made them an increasingly effective oversight tool.

—*Exchange Database System.* The Commission also has significantly enhanced its ability to detect trading abuses through development of the Exchange Database System ("EDS") in 1986. EDS is an automated trade practice surveillance system which permits computer-assisted analysis of trade register tapes (required to be maintained by the exchanges under Commission Regulation 1.35(e)), obtained from each exchange on a monthly basis. It provides the means to organize trade data concerning each futures transaction, using more than 30 programs designed by CFTC staff to facilitate the detection of patterns of potential trading violations, enhancing the ability of the Commission and other law enforcement officials to conduct investigations. Trade practice investigations can be conducted more efficiently and intensively since the implementation of EDS. Trade practice investigations that result in the detection of possible violative activity are referred either to the exchange on which the trading took place for further investigation and disciplinary action, as appropriate, or to the Commission's Division of Enforcement. The Commission's trade practice oversight program uses all weapons at the Commission's disposal, including surveillance, enforcement, and coordination with criminal investigatory authorities, as appropriate.

The Commission also has established computerized data bases for use in its market surveillance and financial surveillance programs that facilitate improved oversight of exchange programs in these areas and enable the Commission to identify areas for investigation and follow-up by the self-regulatory organizations.

All of these programs are intended to assure adequate coverage of the volume and diversity of products traded from a compliance perspective.

—*Improved Financial Surveillance.* Improvements in the Commission's financial surveillance oversight program include modifications of oversight procedures such that reviews of SRO programs are conducted on an intermittent and ongoing basis, as opposed to the previous biennial basis. Commission staff now make on-site visits to the SRO's every several months to review one or more program elements and otherwise for cause. The Commission also added to its financial rule enforcement reviews an examination of clearing organization financial surveillance programs over their member firms; developed formal written procedures to be employed in the event of a financial emergency involving financially troubled futures commission merchants ("FCM's"); established formal documentation and follow-up procedures for all notices received pursuant to its "early warning system" (regulation 1.12 notices), which includes, among other things, a requirement of notice to the Commission of material inadequacies in internal control and of reduction in a firm's capital below 150 percent of the Commission's minimum financial requirements; and implemented formal procedures for monitoring and documenting the execution of financial surveillance by the SRO's over their member firms during volatile markets. These programs were developed to increase surveillance of concentrated positions and to address financial integrity concerns raised by options trading.

—*Improved and Intensified Follow-up Actions.* Following a rule enforcement review, an exchange generally is requested to provide a response within 60 days outlining the steps it intends to take to implement the Division's recommendations. To facilitate review of exchange actions taken in response to rule enforcement reviews, the Division of Trading and Markets, in certain cases, has required exchanges to submit logs reflecting specified exchange self-regulatory activities in order that the Division can monitor improvements in such areas more closely.

As a further means of effecting improvements in exchange self-regulatory programs, the Commission has initiated five enforcement proceedings since 1982 to sanction exchanges that have failed to discharge their self-regulatory responsibilities.

(2) *Improved Registration and Fitness Screening for Commodity Professionals.* Since 1982, the Commission has extended its regulatory framework to new categories of registrants, established improved fitness screening requirements, established an employer sponsorship requirement for associated persons (registration category including salespersons), required new registrations for firms upon changes in the governance of such registrants, and adopted rules implementing the statutory disqualification provisions of the Futures Trading Act of 1982.

(3) *Established Greater Supervisory Accountability.* In the past 7 years, the Commission has stepped up its use of administrative and federal court proceedings to enforce the supervisory responsibilities of Commission registrants under Commission Regulation 166.3. The Commission has also stressed the importance of adequate internal controls at FCM's and of reporting of material inadequacies in such controls by certified public accountants such that the Commission and affected self-regulatory organizations can target their oversight programs to address specific areas of potential problems. The Commission has initiated two cases alleging failures by accountants to comply with their duty to report material inadequacies in internal controls at FCM's for which they conducted audits. These actions also extend the mechanisms available for detecting matters that require further action in a resource sensitive manner.

(4) *Extended Regulatory Framework to New Products and Trading Systems.* The Commission approved the first stock index products in 1982, approved the first international trading linkages (Chicago Mercantile Exchange-Singapore International Monetary Exchange, Ltd. and Commodity Exchange, Inc.-Sydney Futures Exchange, Ltd.) in 1984 and 1986, between 1982 and 1987 developed and expanded a regulatory framework and pilot program for options trading, approved the first evening trading session on a futures exchange, instituted rulemaking proceedings to address jurisdictional issues relating to "hybrid" transactions conducted off of designated futures exchanges, and in 1989 approved a computerized trading system. The Commission also extended its rules for the offer and sale of domestic futures products to U.S. resident customers to the offer and sale of all futures products, wherever originated, to such customers. All of these measures permitted innovation while tailoring the Act's protections of customers and the marketplace to new situations.

(5) *Addressed the Need for Adequate Information Exchange and Regulatory Coordination for Monitoring of Related Markets.* Since 1982, the Commission has:

—Participated in the Presidential Working Group, Intermarket Surveillance Group, Clearing Bank/Clearing Organization Roundtable and other vehicles to foster intermarket surveillance and coordinated clearing and settlement;

—Encouraged formation in 1982 of the Joint Audit Committee to coordinate audit and financial surveillance among all futures self-regulatory organizations and, in 1989, of the Joint Compliance Committee to address trade practice surveillance and compliance issues; and

—Established formal and informal information-sharing agreements with Singapore, Australia, the United Kingdom and other jurisdictions to facilitate surveillance of related markets and cross-border market participants and to eliminate certain duplicative regulatory requirements for multinational firms.

All of these measures address the increasing interrelatedness of markets and the need to adequately communicate on an ongoing and emergency basis in the global marketplace.

2. *Improvements in Exchange Self-Regulatory Programs.*—A second measure of the effectiveness of the Commission's oversight programs is the extent to which those programs have resulted in better exchange self-regulation. As you know, the Commodity Exchange Act contemplates a two-part system of market regulation under which the exchanges are charged with direct self-regulatory duties and the Commission oversees and supplements exchange self-regulation. The Commission's rule enforcement review process has resulted in continuing improvements in exchange self-regulatory programs. Each of these programs is individually assessed from the point of view of its design and execution and subsequently evaluated based upon its responsiveness to prior Commission recommendations. The Commission then makes these evaluations public, a further incentive for better exchange programs.

Although the Commission principally relies upon qualitative rather than quantitative standards in assessing exchange self-regulatory programs, both quantitative and qualitative measures reflect improvements in exchange programs. For example, there have been substantial increases in the levels of sanctions imposed on members found to have violated exchange rules, in the resources and personnel dedicated to exchange compliance activity, in the exchanges' computerized surveillance capabilities and in the quality of financial surveillance conducted by the exchanges and their clearing organizations. Program improvements made by the exchanges in response to Commission oversight recommendations and market events include:

—*Improved computer capabilities.* By the end of fiscal 1986, almost all exchanges had some form of computer-assisted trade practice surveillance system in place.

—*Increased compliance staffs:*

CBT:	
1982	48
1988	83
CME:	
1982	37
1988	89
NYMEX:	
1982	15
1988	33

—*Increased exchange monetary sanctions for trade practice violations:*

1982—$302,880 (excludes MidAmerica Commodity Exchange)

1988—$1,751,672

—*Financial surveillance enhancements.*—The exchanges have substantially strengthened their financial surveillance programs in response to Commission reviews and recommendations. For example:

—All clearing organizations now have authority to make intra-day margin calls and maintain appropriate computer systems for calculating and tracking the receipt of such calls.

—Within the past year, using a newly-designed system to electronically transmit and receive information, margin pay and collect data are now shared daily between exchanges for those firms which hold multiple memberships and the Commission is working to get the securities derivative markets to participate in this process.

—Other exchange financial surveillance program features adopted or enhanced due to Commission encouragement include: tightening of capital-based position limits for futures and options, greater controls over floor trader account deficits, increased review of intra-month net capital compliance, and greater use of large trader position data for financial surveillance and concentration monitoring.

3. *Effectiveness of the Futures Regulatory System During Market Strains and Disruptions.*—A third test of the effectiveness of a regulatory oversight program is the extent to which it provides effective safeguards in periods of market stress. The October 1987 market break provided an operational test of the effectiveness of the CFTC's financial oversight system in protecting futures customers and futures customer funds in a period of extreme market turbulence. During the market break, the financial safeguards of the futures markets operated effectively such that:

—No customer funds were lost as the result of a futures firm failure or default;

—No FCM failed;

—The daily clearance and settlement systems of the futures markets functioned well despite margin flows of unprecedented size, resulting in the collection of all margin payments due from clearing firms, including daily and intra-day variation payments of as much as $2.5 billion in a single day; and

—The futures exchanges maintained effective financial surveillance, provided relevant financial data to the Commission, called for frequent intra-day margin payments, tightened requirements for exemptions from speculative position limits, and took other appropriate actions in light of the unusual market volatility.

The demonstrated strength of customer fund protections during the October 19–23, 1987 period accords with the historically low incidence of insolvency loss—approximately $10 million over a 50-year period—for futures customers. This compares favorably with the average of $10 million paid out each year by the Securities Investor Protection Corporation to reimburse losses by customers of securities brokers.

4. *Public Confidence in the Futures Markets.*—One gauge of the effectiveness of oversight of a financial marketplace is the level of confidence in the regulated market demonstrated by the users of that market. It is frequently remarked that the U.S. futures markets are the most liquid, successful, and sought-after in the entire world. Foreign regulators have in many instances looked to the CFTC's regulatory program as a model for their own regulatory structures. Tangible indices of public confidence, such as high trading volume and low numbers of customer complaints, provide strong reason to believe that a high level of public confidence in the futures markets exists.

During the first 3 months of 1989, trading volume on the U.S. futures and options markets was more than three times as great as the trading volume of the 17 principal foreign futures and options markets combined. Available data indicate that trading volume in the U.S. futures markets has increased, despite widespread publicity concerning the ongoing Chicago and New York investigations. Futures and options trading volume for the first four months of 1989 increased by 16.62 percent over the same period a year earlier.

Another gauge of the level of public satisfaction with the futures markets is the infrequency of customer complaints arising from futures trading activity. Data compiled during a period of extreme market stress—the October, 1987 market break—demonstrate a very low number of futures customer complaints. As reported in a January 1988 CFTC staff report, the futures exchanges which trade stock index products, the National Futures Association, and the CFTC's reparation forum reported a total of only 35 customer complaints relating to stock index trading on futures exchanges during the October 16 through October 23, 1987 period. During this period, more than 2,800 traders participated in these markets. Similarly, information from 23 FCM's active in Standard & Poor's 500 futures and options contracts, representing two-thirds of all customer equity in that contract, identified a total of only 73 customer complaints for the same period. These figures can be compared to 14,430 oral and 1,973 written complaints relating to the market break that were received by the SEC and securities self-regulatory organizations, as reported in the SEC's report on the October 1987 market events.

5. *External evaluations.*—The effectiveness of the Commission's oversight program has been confirmed by the evaluations of third parties who have reviewed the CFTC's performance. In studies of the October 1987 market crash by outside evaluators, the CFTC's oversight program received generally high marks. The Brady Commission concluded that the CFTC should retain its jurisdiction over futures markets based on its "expertise in the design and regulation of futures contracts and markets." The Brady Commission spoke approvingly of the CFTC's regulatory framework, as contemplated by the Commodity Exchange Act, of direct regulation by industry self-regulatory organizations (*i.e.*, the exchanges and the National Futures Association) under CFTC oversight.

The General Accounting Office has noted that self-regulatory organizations and federal regulators implemented procedures to respond to high volatility in their markets during October 19 and 20, 1987, chiefly by intensified oversight activity. GAO further noted that throughout the crisis, CFTC oversaw the actions of the futures exchanges. The GAO summarized the CFTC's activities as follows:

CFTC intensified its routine surveillance of stock index futures on October 6, when the DJIA fell nearly 92 points. On October 16, when the DJIA experienced a 108 point drop, CFTC scheduled a special market surveillance briefing for the morning of October 19. CFTC invited SEC staff to brief them at the meeting. CFTC reviewed the largest futures positions and position changes in the S&P 500 futures contract and also provided preliminary estimates of the magnitude of index arbitrage and portfolio insurance. CFTC surveillance staff telephoned market users to obtain explanations of their futures market activity and to receive first-hand assessments of market conditions. CFTC also implemented its financial early warning system whereby they are notified when market participants which carry customer accounts fall below 150 percent of their minimum capital requirements.

Further, in connection with each reauthorization since 1978, the GAO has reviewed the oversight activities of the CFTC. The most recent recommendations from GAO as a result of these reviews were issued in a full report in 1982 and by letter of December 20, 1985 concerning audit trails. In each case, the CFTC has implemented the GAO's recommendations.

CONCLUSION

The CFTC has deployed the resources available to it to respond to market developments and to improve the effectiveness and efficiency of its own regulatory framework and the self-regulatory programs of the futures exchanges. This overview addresses only some aspects of the CFTC's programs. Other developments since 1982 include development of a regulatory framework for commodity broker bankruptcies, improved regulation of managed funds, application of speculative limits to all markets, refinement of the hedging definition, and publication of major oversight reports on the silver market of 1979–80, exchange of futures for physicals (EFP) transactions, and the October 1987 market events. The Commission will continue to assess its effectiveness and stands ready to take all action necessary to protect the integrity of U.S. futures and options markets.

Dr. **GRAMM**. I would like to make one point about the measure of success, and I recognize it is an ongoing process, and it is one that involves using a lot of information, a lot of data, but again I use a lot of information, the Commission uses a lot of information, and I recognize that the kind of information that we can provide to you obviously is something that we will provide to help you in your oversight of the Commission. I hope that you will consider more than just process, that you will consider a wide range of indicators of our success. I would say that that measurement is not an easy one because we find out more information all the time.

If we had hard numbers so that we could verify the number of violations occurring on the floor, not only on the floors but also in the retail area, and also how many fraudulent bucket shops are out in the world and then measure that against what we find and what we deter, I think that would be great. But that is like finding out how many speeders there are on the highways. There is some information that is very difficult to get.

The Commission spends a lot of time and effort carrying out the Commodity Exchange Act, particularly in the customer protection area, but there is a large range of other activities that the Commission does.

Senator **DASCHLE**. Well, I can appreciate all of that, but I have to tell you this is one Senator who when we come up with reauthorization is going to be very concerned about that, and will write in our own into law, if we have to, to see that not only the substance but this perception is addressed more effectively in the future.

Dr. **Gramm**. Yes.

Senator **Daschle**. But we have to be able to answer the question a lot more successfully than we were able to answer it this morning, to be honest with you. We have to be able to do that, and we can come up with 100 reasons why it is difficult, but if we cannot come up with a better reason than we did this morning, then I think we have to address it in law. Thank you, Mr. Chairman.

Dr. **Gramm**. The trade practice area has always been in the top two or three in terms of our resource use, the other one being fraud.

Senator **Daschle**. Well, put that in the answer.

Dr. **Gramm**. Yes.

The **Chairman**. Following up somewhat on this, Senator Daschle has talked about the use of undercover agents and others, and I think he expresses the concern being felt by many here in the committee. You have already noted that while the CFTC polices the trading pits itself, you consider the exchanges as being the first line of regulation for them. Your prehearing submission shows a really limited physical presence of CFTC staff on the floors themselves. I think there are perhaps six Trading and Market staff appearing on the Chicago floors maybe two to three times per week.

Anybody who has observed those exchanges realizes that their trading floors are extraordinarily busy. Should you not have a bigger presence on the floors?

Dr. **Gramm**. I should point out that we also have market surveillance staff that does surveillance as well, but that is something that we will certainly——

The **Chairman**. Well, that requires a computer to do as much as anything else.

Dr. **Gramm**. With respect to the floor surveillance, we do go on the floors of the exchanges—the Chicago exchanges in particular—several times a week and we feel that it helps to deter some abuses, and also it keeps our staff apprised of what new kinds of trading patterns may be emerging. It is a way to gather information. There are some things that are not easy to observe, and there are some kinds of violative activity that occur off the floor that we could not check. But that is something we will consider.

The **Chairman**. Some of it may occur on the floor, too of course. When we had the GAO here 2 weeks ago, they noted that the computerized audit trails could follow trading on the exchange floors effectively within about 85 percent of the time. Fifteen percent of the time, they could not. This is an oversimplification, but we asked the GAO at that time whether somebody who really wanted to could put themselves into that 15 percent. They said yes, the answer was yes they could, if they wanted to.

A physical presence on the floors, as you said, has a deterrent effect, and it also has an investigatory effect. I am just wondering whether we should not be looking to the fact of having more people there.

Dr. **Gramm**. Well, that is certainly something we will consider. Again, I think it is important to note that some violative activity—

even that which occurs on the floor—is very hard to observe. And then there is prearranged trades which take place off the floor.

The Chairman. Prearranged trades, for example.

Dr. Gramm. That is right.

The Chairman. Prearranged trades would be very difficult to detect, even with somebody standing right there.

Dr. Gramm. That is right. Also, if somebody puts a different time bracket on their card or puts some information down that is not correct.

The Chairman. Well, suppose you decided after you thought about this that indeed, from a deterrent point of view, from an investigative point of view, you should have more than those half-dozen people on the floors, perhaps two or three times that number. Would you be able to do it? I mean, suppose you made the policy decision this is a good idea. Could you do it? Do you have enough people?

Dr. Gramm. We have a certain number of people at the Commission, and the question is what would they not be able to do if they were to spend more time on the floor of exchanges. Obviously, that is something that we are considering, should consider, and you know, the question is, I guess pardon me if I say it, the marginal benefits and the marginal costs, the marginal costs being the opportunity costs of what they would be doing otherwise.

The Chairman. Or is this an either/or proposition? I mean, would you have to take them away from reviewing exchange rules or preparing rule enforcement reviews, or whatever?

Dr. Gramm. That is right.

The Chairman. Or should you seek more resources and hire more people to do just that?

Dr. Gramm. One could do that as well. But even if you hired new people, there are alternative tasks that could be undertaken as well.

The Chairman. I understand. I think, though, that you are going to have to consider where this lies in the hierarchy of importance.

Dr. Gramm. Right. Absolutely. And you should know as well that when we have overseen exchanges that we also have suggested, I know at least of one instance that they do have some more floor monitoring at the exchange.

The Chairman. Each of the last several years, the CFTC has asked the Congress for more budget for enforcement. And the staff has grown slowly over the years. Is it growing fast enough to keep pace with the rate of growth in the industry itself, the enforcement staff?

Dr. Gramm. Let us put it this way, when we were putting together budget figures for 1990, we put in what we thought was a responsible amount knowing that——

The Chairman. Is it enough?

Dr. Gramm. I am not sure. We might need more, especially if we find that we will be using a lot more resources after the investigation occurs. We may amend that.

The Chairman. Well, you brought trade practice enforcement cases against 97 people since the first of January 1983. That is around 16 a year.

Dr. Gramm. Yes.

The **Chairman**. What is the basic difference between the cases you bring and the actions taken by the exchanges? For example, your 97 cases, are these really instances of where the exchange should have acted but failed to do so, and thus you had to step in because they did not do their job? Or do you go into difficult cases that they are not set up to handle?

Dr. **Gramm**. Well, the variety of reasons including the ones you mentioned.

The **Chairman**. In other words, both of those?

Dr. **Gramm**. Yes. Dennis, would there be any other situations?

Mr. **Klejna**. That is generally accurate, Senator. In addition, an exchange when it disciplines someone is limited obviously to dealing with that individual with respect to his membership on that exchange, and to the extent that the conduct may have been sufficiently egregious that his registration should be dealt with from a Federal level, then, it may be the same facts but the remedy could be broader if it is imposed by the Commission. But generally your first two observations are accurate.

The **Chairman**. A number of these cases are settled before they go to a hearing in front of an administrative law judge, are they not?

Dr. **Gramm**. Yes.

The **Chairman**. Do you feel sometimes that you have to settle cases just because you do not have the resources to push forward the litigation? Does that become a decision to settle?

Dr. **Gramm**. Litigation?

Mr. **Klejna**. That is always a litigation element among many others. It is not a matter, I do not know that I would say resources is the driving force, but certainly you have to look at the costs and benefits of proceeding with the litigation, and given what else you have to do. That is one of many considerations.

The **Chairman**. What is a norm in penalties that you give out? Do they go all over the place? I am just curious. You can go up to $100,000.

Dr. **Gramm**. $100,000 per violation.

The **Chairman**. Have you ever handed out any $100,000 fines?

Dr. **Gramm**. What is the range we have had?

Mr. **Klejna**. Well, for example, there was a trade practice matter that was resolved by way of contemporaneous consent filing in the fall involving Mocatta Metals and another Mocatta firm, large members of the Comex, and Drexel Burnham Lambert, and the combined civil penalties there were in excess of one-half of a million dollars.

Obviously there are other cases where it could be much less than that. To tell you the truth, we could probably figure out a norm for you, but I could not do that now.

The **Chairman**. You have even gone down as low as $1,000, I take it?

Mr. **Klejna**. Sure. It could be fairly small.

The **Chairman**. When I see something that small, I just wonder if that case was one that should have been handled by the exchange rather than bringing in the admittedly limited resources of the CFTC?

Mr. KLEJNA. Well, what it comes out to in the end is not necessarily what you would have expected at the beginning in every case. And usually that is not the case. Most trade practice matters involve I would say, I would say rarely would be the trade practice case where a civil penalty is that small.

The CHAIRMAN. I do not want to fall into the trap of saying that we will stop all crime by simply increasing the penalties without doing anything to help catch the people violating the laws. I realize first and foremost that the best deterrent is some assurance that violators are actually going to get caught and be penalized. But, assuming that you can catch people, there must be some egregious cases that the $100,000 ceiling may limit your ability to bring effective action. Would there be any sense to raise it? Would it provide a more deterrent if the CFTC were authorized to impose penalties of two or three times the current $100,000 limit?

Dr. GRAMM. That certainly is something worth considering.

The CHAIRMAN. Will you think about it and give me your thoughts?

Dr. GRAMM. Yes. Another thing to remember, too, is that sometimes a civil penalty is combined with other restrictions such as——

The CHAIRMAN. I understand. Can you stop somebody from being able to trade for a period of time?

Dr. GRAMM. That is right, and that is very costly.

The CHAIRMAN. I understand. In some instances, that may cost a rule violator much more than the fine. Is that correct?

Dr. GRAMM. That is right.

Mr. KLEJNA. If you put somebody out of business, exactly right. It is far more dangerous and a lot of people would be more willing, for example, to pay a civil penalty rather than even be forced out of business for a week. But to elaborate a little further, Senator, the statute itself requires additional considerations by the Commission in imposing a civil penalty including if the person is in the commodity business, the impact of the person's ability to remain in the business by the imposition of that fine among other things.

The CHAIRMAN. The SEC issued a report at the end of last year in which they said that they had some problems in attracting skilled staff professionals. The problem was worse for lawyers, particularly in New York and Chicago. People were leaving the agency after a couple of years since they could make considerably more money out in private sector jobs. A lot of people make this complaint. I mentioned a little while ago about having to leave for the Judiciary Committee. I see staff people just 3 or 4 years out of law school leaving there to make a lot more money than any of the Senators on the committee. That attracts them.

I am just wondering have you had the same problem?

Dr. GRAMM. Definitely, and I would say it is not only in the legal profession, but also financial economists, for example, can make a lot more in academia than in public service. Also we have had difficulty competing at the support staff level, particularly in New York and Chicago.

The CHAIRMAN. When I was a prosecutor, I was constantly impressed by the fact that the more serious the case that I was prosecuting, the greater the multiples of my salary with that of the defense attorney. If you had a really serious case, then you could get into multiples of 5, 6, 7, 8, 9, 10 times. Do you find the same thing happening where your lawyers and investigators are on a serious case and they know that the people they are up against defending the case are making an awful lot more money?

Dr. GRAMM. Absolutely.

The CHAIRMAN. What do we do about it?

Dr. GRAMM. Well, again, recruiting and retaining good personnel is very difficult.

The CHAIRMAN. Well, what do we do about it?

Dr. GRAMM. The Division of Enforcement has made a special effort to recruit people to public service. They are not making the money that they could out in the private sector. Right now, I would say the Division of Economic Analysis is the area in which we have a large number of vacancies. So it is a very, very difficult problem, I think, for all of government.

The CHAIRMAN. I want to close with this request. There have been many ideas on how we should improve futures regulations since the recent reports have arisen in the press out in Chicago. I want to consider the best of these when we put together the CFTC reauthorization bill this year. So I am going to ask that, within 30 days, you provide us with an analysis of the pros and cons of a number of proposals which have been discussed over the past 2 months to tighten exchange floor oversight.

The list is not exclusive. There will be other good ideas, and we will pick from among those. I am not trying to prejudge the outcome of the probe. I have not prejudged the wisdom of any of these approaches. We will, of course, ask for similar comments from industry groups, market users, traders, and the public. Here are the proposals:

Proposals

One, requiring exchanges to devote more of their resources to floor surveillance and compliance.

Two, requiring greater representation on exchange governing boards of such nonfloor membership interests as wire houses and trade firms, and of public members.

Three, barring exchange members with significant disciplinary records from serving on exchange disciplinary or oversight panels.

Four, increasing penalties for trading abuses by, for instance, authorizing the CFTC in egregious cases to fine a violator up to triple the amount of any pecuniary gain resulting from the violation—an approach similar to the SEC "insider trading" statute—or allowing private parties in egregious cases to sue for punitive damages under the Commodity Exchange Act.

Five, requiring all broker associations to register and limiting trading among association members.

Six, curbing dual trading in any pits where the exchange audit trail cannot demonstrate a 1-minute accuracy rate of, say, 90 percent or better, and where liquidity is already adequate to fill customer orders efficiently.

Seven, mandating improvements in exchange audit trails under CFTC Rule 1.35, including perhaps narrowing the 1 minute standard to a smaller time increment.

Eight, increasing the physical presence of CFTC or exchange compliance staff on exchange trading floors.

Nine, barring oral orders on the floor and narrowing the price range during market openings and closings.

Ten, adjusting CFTC personnel rules to better attract and keep qualified and experienced attorneys, auditors, and other professionals.

Eleven, increasing CFTC powers and/or resources.

Twelve, any other proposals which you feel that the committee should consider in this process.

I will have someone give your staff a xerox copy of those 12 proposals.

[The prepared closing statement of Chairman Leahy follows:]

PREPARED CLOSING STATEMENT OF HON. PATRICK J. LEAHY

I have a closing request. Many ideas for improving futures regulation have come up in the wake of the recent Chicago revelations, and we want to consider the best of these in preparing any CFTC reauthorization bill this year. Your expert advice will be very important to this process.

To get the ball rolling, would the CFTC, within 30 days, please provide us with an analysis of the pros and cons of the following proposals which have been discussed over the past 2 months to tighten oversight of the exchange floors. This list is not exclusive. Other good ideas will doubtless come up along the way on which we will seek your guidance. The committee has not yet judged the wisdom of any one of these approaches, nor do we prejudge the outcome of the Chicago probe. Our goal, rather, is to begin to focus the public debate on tangible reforms aimed at maintaining confidence in the marketplace.

Thank you in advance for your cooperation. We also, of course, invite comment from industry groups, market users, traders, and the public on these ideas.

The proposals are as follows:

1. Requiring exchanges to devote more of their resources to floor surveillance and compliance;

2. Requiring greater representation on exchange governing boards of such non-floor membership interests as wire houses and trade firms, and of public members;

3. Barring exchange members with significant disciplinary records from serving on exchange disciplinary or oversight panels;

4. Increasing penalties for trading abuses by, for instance:

(i) Authorizing the CFTC in egregious cases to fine a violator up to triple the amount of any pecuniary gain resulting from the violation [an approach similar to the SEC "insider trading" statute], or

(ii) Allowing private parties in egregious cases to sue for punitive damages under the Commodity Exchange Act;

5. Requiring all broker associations to register and limiting trading among association members;

6. Curbing dual trading in any pits where the exchange audit trail cannot demonstrate a one-minute accuracy rate of, say, 90 percent or better, and where liquidity is already adequate to fill customer orders efficiently;

7. Mandating improvements in exchange audit trails under CFTC rule 1.35, including perhaps narrowing the one minute standard to a smaller time increment;

8. Increasing the physical presence of CFTC or exchange compliance staff on exchange trading floors;

9. Barring oral orders on the floor and narrowing the price range during market openings and closings;

10. Adjusting CFTC personnel rules to better attract and keep qualified and experienced attorneys, auditors, and other professionals;

11. Increasing CFTC powers and/or resources; and

12. Any other proposals which you feel that the committee should consider in this process.

Dr. **GRAMM**. Right.

The **Chairman**. But think about them. And if we have missed something, then please include them in what you send back because I think that the reauthorization is the time to raise these issues. I am trying to cover issues that I have heard in the questions of many Senators from both sides of the aisle. If there are other suggestions that other Senators have or if Senator Lugar or anybody else has other ideas, we will pass those on too. We really would like your most candid, best analysis of them. Ignore, to the extent you can, any politics or thoughts of whether we can or cannot pass the proposals or what the debate would be like. That will be our problem. That will be the House's problem. But tell us frankly whether they are good ideas or bad ideas. And then we will go from there.

Dr. **Gramm**. We would be happy to, and we would like to include in that other, other ideas that we may have as well.

[The responses from Chairman Gramm concerning the proposals were subsequently supplied for the record and follow:]

Commodity Futures Trading Commission,
Washington, DC, *April 25, 1989.*

The Honorable Patrick J. Leahy,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, SR-433, Russell Senate Office Building, Washington, DC.

Dear Chairman Leahy: On March 9, 1989, you asked the Commodity Futures Trading Commission to comment on various proposals designed to tighten oversight of floor trading. Prior to your request, the Commission had decided to review its oversight programs and, as part of its ongoing oversight activities, to ask each exchange to review certain aspects of its regulatory programs.

On February 7, the Commission requested each exchange to focus on certain issues related to trade practice surveillance in the course of their self-regulatory reviews. Many of the issues we asked the exchanges to consider were similar to those you have raised. Furthermore, on March 8, the Commission also asked each exchange to review further its audit trail systems to ensure that they meet the performance standard set by Commission rule, and to assess how to improve the effectiveness of its systems to address trade practice abuses. The Commission also began its own assessment of dual trading and directed the exchanges to provide certain data and analysis to assist in this effort.

In response to the Commission's letters, and in keeping with their legal obligation to maintain effective compliance programs, the exchanges began reviews of their regulatory programs to determine whether changes are necessary. As evidence of the responsiveness of the self-regulatory system, two exchanges, the Chicago Mercantile Exchange and the Chicago Board of Trade, have already reported significant planned improvements to their programs. The Commission expects to receive responses from each of the exchanges.

As you continue your review, the Commission is pleased to forward its response to your March 9 proposals. The Commission's recommendations are set forth here.

1. Support increases in exchange resources for surveillance and compliance programs, including floor surveillance. Neither legislation nor Commission rulemaking is necessary to implement this proposal.
2. Support broad-based representation on exchange governing boards, including representation of non-floor membership interests, non-member user interests, and other public members. Monitor governing board composition.
3. Support banning members with significant disciplinary records from service on exchange disciplinary or oversight panels for an appropriate period of time. Promulgate rules to address this matter.
4. With regard to penalties, recommend alternatives to treble and punitive damages:

—Recommend that the Commodity Exchange Act (Act) be amended to provide for the automatic suspension of Commission registrants and automatic suspension of trading privileges upon a failure to appeal from or pay a civil monetary penalty order within 15 days from the expiration of the period fixed for compliance with the order;

—Recommend that the Act be amended to delete the requirement of Section 6(d) that the Commission consider net worth and ability to continue in business in assessing civil penalties;

—Recommend exchanges review their penalty structures and consider adopting penalty guidelines where appropriate;

—Review CFTC policy regarding penalties.

5. Gather more information on broker associations in order to assess the appropriate definition of broker associations, and the advisability of requiring registration of or imposing limits on broker associations.

6. Study dual trading to assess if it should be limited or banned based on audit trail performance standards and on liquidity, and whether other actions are appropriate.

7. Study methods to improve compliance with current audit trail requirements. Pending completion of studies, do not recommend mandating the narrowing of the one-minute standard.

8. Support, in concept, increasing the physical presence of exchange and Commission compliance staff on exchange trading floors.

9. Undertake rulemaking regarding oral orders to improve monitoring or to limit oral orders. Also, consider alternatives to narrowing the price range during opening and closing of trading.

10. Recommend, as an alternative to adjusting personnel rules, government-wide salary increases designed to broaden the pay ranges of the GS, GM, and SES levels to include additional steps at higher salary levels.

11. Request additional resources for FY 1990—20 staff-years to be devoted to trade practice surveillance, investigation and prosecution of trade practice abuses, enhanced surveillance, and enforcement of other types of violations. Consider additional resource needs in FY 1991 requests.

12. Recommend legislation to require registration for floor traders.

Review and direct exchanges to review possible modifications to opening and closing procedures, such as single price and average price opening and closing procedures, or narrower opening ranges, and ways to address trading after the close.

The Commission's assessment is ongoing. As changes become warranted, the Commission assures you that the necessary actions will be taken. Of course, you understand any rulemaking or study must take account of individual differences among the exchange markets. To the extent that further information not addressed by these proposals develops from the undercover investigation in Chicago, the Commission stands ready to take other appropriate actions.

Sincerely,

WENDY L. GRAMM.

NOTE.—Identical letter sent to Senator Richard Lugar.

[The proposals follow:]

PROPOSAL 1: Requiring exchanges to devote more of their resources to floor surveillance and compliance.

BACKGROUND

Section 5 of the Commodity Exchange Act ("CEA" or "Act"), Commission Regulation 1.51 and Guideline No. 2 require that exchange self-regulatory programs be sufficiently budgeted and staffed to maintain an effective affirmative compliance program to deter, detect, and sanction practices which lessen the competitiveness of trading or take advantage of customers.[1] Each exchange must have a program reasonably calculated to enforce its rules and which includes, among other program elements, periodic floor surveillance.

The Commission's oversight program currently considers on a case-by-case basis whether each exchange commits sufficient resources to its self-regulatory programs to make them effective. Examples of where resources are required to be applied by exchange compliance programs include floor surveillance, record surveillance, computer-assisted data analysis systems, and disciplinary proceedings.[2] Generally, the Commission has not dictated precisely how each exchange is to commit its resources to various parts of its compliance program, specifically because exchanges need the flexibility to apply their resources for that purpose in the most efficacious manner. However, the Commission also has not hesitated to recommend that increased resources be committed to compliance programs or that changes be made in how resources have been applied wherever necessary. As an example, Commission recommendations resulted in all exchanges developing computer assisted trade practice surveillance capabilities over the past few years.

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[1] Guideline No. 2., 1 Comm. Fut. L. Rep. (CCH) ¶ 6430 (May 3, 1975). That Guideline specifically states that: It is the obligation of every contract market to make whatever modifications in its self-financing scheme as are necessary to enable it to adequately fund an enforcement program which will protect the public interest.

The Guideline further provides that: such exchange has the obligation of having a suitable staff engaged in actively and continuously looking for possible violations regardless of whether the exchange has received any customer complaints, referrals from the Commission, etc. The Commission believes that an exchange cannot meet its obligation under Section 1.51 merely by utilizing member officers or committees as its sole enforcement staff.

As a result of Commission recommendations, since the inception of the Commission's trade practice rule enforcement review program in 1976, exchange resources devoted to self-regulatory compliance programs have increased approximately five-fold. Further, a number of exchanges have indicated that in 1989, based on internal evaluations of compliance needs, their compliance budgets for salaries and benefits will be increased both in absolute terms and as a percentage of exchange budgets as a whole. Additionally, resources increasingly are being applied to program design and maintenance of computer-assisted surveillance of trading, electronic order delivery systems, and other technological improvements to surveillance efforts. Also, since the Chicago undercover investigation became public, a CME special committee recommended allocating additional resources to floor surveillance and other exchanges are considering this issue.

Although the proposed exchange budget increases respond to growth in trading volume, the need to monitor new products, and expected electronic trading systems, the increases also are targeted to enhancing existing compliance programs' deterrence and detection capabilities, including increasing the frequency and effectiveness of computerized surveillance. Increased funding will be used to hire additional compliance staff as well as to retain experienced personnel.

DISCUSSION

The exchanges currently have a legal obligation to expend sufficient resources on compliance. The Commission believes that most exchanges generally fulfill that obligation. In rule enforcement reviews, however, Commission staff, when appropriate, has cited the need at particular exchanges to increase staffing, to improve supervision of the surveillance or investigative process, and/or to enhance technical assistance and computer capabilities.[3] This targeted approach permits suggestions to be tailored to the characteristics of particular exchange markets. It also facilitates follow-up if improvements are not observed.[4] The exchanges generally have been responsive to such suggestions, and it has not been necessary to address exchange use of resources by additional Commission rulemaking.

Further, the Commission customarily does not use a specific level of funding as a barometer of effectiveness. Rather, the Commission assesses whether the design and execution of exchange programs are adequate to deter and detect abusive trading practices. Consequently, the performance of a small but qualified compliance staff at one exchange may be superior to that of a more costly but poorly-administered or less-expert compliance staff at another exchange. Moreover, the performance of audit trail systems which rely on manual reporting may be equivalent to the performance of those that use complex computer algorithms, although the latter systems are more costly to develop and operate.

The Commission believes that it would be extremely difficult to mandate explicit resource levels, either by legislation or rulemaking. Requiring explicit resource commitments might result in misplaced emphasis on input (costs) rather than output (results). As discussed above, the effectiveness of surveillance and compliance programs depends as much on how resources are employed as how many are allocated to any given task. For example, unlike most exchanges the Chicago Mercantile Exchange ("CME") and the New York Cotton Exchange ("NYCE") have full-time floor surveillance staff. However, although floor surveillance is useful, record surveillance may be more efficient for detecting trading abuses in certain markets (see also Proposal 8). As a general rule, the Commission believes that each exchange must determine how best to deploy its resources, consistent with the requirement that it maintain an effective affirmative compliance program.

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[2] Commission Regulation 1.51 requires each exchange to include in its compliance program surveillance of market situations, surveillance of trading practices, record surveillance investigation of customer complaints and of all other alleged or apparent rule violations, and procedures to take prompt and effective disciplinary action.

[3] For example, in the March 27, 1987 review of the New York Mercantile Exchange ("NYMEX") and the September 25, 1987 review of the Commodity Exchange, Inc. ("Comex"), the Division of Trading and Markets recommended that both exchanges enhance their computer-assisted surveillance capabilities by developing programs which are designed initially to identify for further investigation possible illegal trading activity.

[4] In its March 22, 1988 rule enforcement review, the Division of Trading and Markets found that the Minneapolis Grain Exchange ("MGE") had conducted no investigations of trade practice violations and, thus, had taken no disciplinary actions. MGE's failure to maintain an adequate surveillance program had persisted over a period of time. As a result, an administrative proceeding was brought against the Exchange by the Commission. That proceeding was settled, and, among other things, a civil penalty of $30,000 was assessed.

The Commission notes that a Joint Compliance Committee being organized by the exchanges, with the Commission's encouragement, will be addressing increased floor surveillance and other issues related to improvement of the existing methods and compliance techniques used in surveillance.

Recommendation

The Commission generally supports increases in exchange resources for all of their surveillance and compliance programs, including floor surveillance. A number of exchanges have announced increases in resources for this purpose. The Commission does not believe that legislation or Commission rulemaking is necessary to implement this proposal—current statutory and regulatory authority are sufficient.

PROPOSAL 2: Requiring greater representation on exchange governing boards of such non-floor membership interests as wire houses and trade firms, and of public members.

Background

The Commission has supported diversified board representation and many exchanges currently have rules which provide for some degree of diversification.[5] However, exchange rules and bylaws concerning the composition of governing boards differ greatly in the degree of specificity as to diversification.

Exchanges take many factors into consideration in developing boards capable of addressing the many exchange governance and market problems that arise. Some exchanges formally distribute board representation among sectors of the exchange community by allocating set numbers of board positions to various exchange membership categories (*e.g.*, Comex, NYMEX, the Coffee, Sugar and Cocoa Exchange ("CSC"), MGE, and the New York Futures Exchange ("NYFE")); [6] others allow the full exchange membership maximum flexibility in choosing its governing boards (*e.g.*, the Chicago Board of Trade ("CBT"), CME, the Kansas City Board of Trade ("KCBT"), NYCE, and the Philadelphia Board of Trade ("PBOT")). In practice, however, the boards of the latter group of exchanges also consist of a cross-section of exchange interests, including floor traders and representatives of wire houses, smaller futures commission merchants and commodity users.[7] Additionally, almost all exchanges have a rule or bylaw which provides for their boards to include non-exchange member.[8] As a result, 12 exchanges have at least two public board members, some of whom may be market users.[9]

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[5] The two exchanges without any rule or bylaw concerning board representation are the Pacific Futures Exchange ("PFE"), which never has listed a contract for trading, and the Amex Commodities Corporation ("ACC"), which currently has no trading. Although the applicable ACC bylaw does not require any particular allocation of Board seats, the ACC's policy has been to provide for representation of various groups. Currently, the Board consists of the ACC Chairman, the ACC President, three wire house representatives, two floor traders, and one metal industry representative.

[6] For instance, Comex Bylaw 102 provides that the 25 Board members shall include seven from the registered Trade Group; seven from the registered Commission House Group; seven from the registered Floor Group; three non-members; and the Chairman.

[7] For instance, of the CME's 24 elected member Governors, seven are independent floor traders; 13 are affiliated with clearing member firms; and four are affiliated with non-clearing member firms. In addition, the CME Board has three appointed non-member Governors and three appointed Governors who are representatives of clearing member firms.

Of the CBT's 20 elected member and associate member Directors, including the Chairman and Vice-Chairman, eight are affiliated with FCM's; six are floor brokers; and six are locals. Of the eight members affiliated with FCM's, three are non-residents, one of whom is a principal of an out-of-town commercial commodities firm; another is a principal of a New York financial firm; and the third is a general partner of a cash grain merchandising firm. In addition, the CBT Board has three non-member Directors.

The Commission, through its Division of Trading and Markets ("Division") reviewed the structure of exchange boards in connection with its study of the silver market of 1979–1980. This review evaluated the capability of exchange boards to respond to developments in a manner designed to promote public confidence that board responses were not the product of self-interest or affected by individual board members' financial interests. In a June 1985 investigative report ("Report") on silver market events, the Division recommended that "each exchange should be required to assure that its governing board meaningfully represents the trading participants at the exchange, including floor brokers, commission houses, commercial trade firms, and interests related to the specific commodities or groups of commodities traded on the exchange."

The Division also recommended in the Report that "each exchange should be required to provide for public representation on its board, with no less than 3 seats [for boards of 20 or more members] or 2 seats [for boards smaller than 20 members] assigned to public directors." The Report suggested these public directors should possess experience or expertise in futures trading generally, or in the specific commodities traded at the exchange, but not themselves be active futures market participants. Existing board structures are generally consistent with these recommendations.

DISCUSSION

The composition of exchange governing boards and, more particularly, of exchange committees responsible for compliance and disciplinary matters are relevant to public perceptions of fairness and effectiveness of those bodies, especially in light of the exchanges' substantial responsibilities for self-governance and compliance as a matter of law.

In addition, the extent to which board membership is representative of member and user interests may affect how a board determines to allocate exchange resources, selects members to serve on exchange disciplinary committees, develops policy objectives, and proposes and implements exchange rules. In addition, board composition may affect the board's direct consideration of disciplinary cases when it acts as the exchange reviewing body of last resort. Broad-based representation of those interests affected by exchange decisionmaking therefore is important to the integrity of self-governance.

Beyond assuring representation of all interests, some advantages of having public member representation are that such members can bring a disinterested point of view to board deliberations and actions, and, further, that such members perform the function of "witnesses," thereby giving some additional assurance of fairness and ensuring that the public interest is being considered. Within the category of public members, including market users on an exchange board provides the additional advantage of having members knowledgeable about the commodities being traded and concerned with market integrity but without the self-interest that can accompany exchange membership.

However, the performance of public directors, as noted in the Report, sometimes was limited by such directors' absenteeism, failure to prepare sufficiently, and failure to provide expert assistance. In addition, some commentators have suggested that public directors frequently vote so as to support the prevailing power structure and therefore are not an effective counterbalance to that structure.

Exchange members and financially-interested or industry-affiliated public directors on exchange governing boards have expertise relevant to handling many exchange governance issues because of their daily participation in the market. Other public board members, in contrast, may not possess such expertise. This does not suggest, however, that market expertise is necessary to address all issues that come before exchange boards or that public members lacking market expertise cannot contribute to exchange governance.

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[8] The rules of all exchanges except ACC and PFE either require such representation or authorize the chairman to appoint a certain number of public board members.

[9] To the extent legislation exists concerning board membership of securities exchanges, the Securities Exchange Act of 1934 provides that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. Securities Exchange Act of 1934 § 6(b)(3). The New York Stock Exchange ("NYSE") quantifies "public" membership on its Board at 50 percent. Many of these public members are affiliated with issuers listed on the NYSE.

RECOMMENDATION

The Commission supports broad-based representation on exchange governing boards, including representation of non-floor membership interests, non-member user interests, and other public members. Most exchanges have a cross-section of members, either by rule or simply as a result of their board elections, and most boards also include public members. The Commission will monitor governing board composition, and if it finds a lack of broad-based representation will recommend changes.

PROPOSAL 3: Barring exchange members with significant disciplinary records from serving on exchange disciplinary or oversight panels.

BACKGROUND

At present, five exchanges have rules related to the fitness of members who serve on disciplinary committees or governing boards. The rules of two exchanges (CME and Comex) are applicable to disciplinary committees and those of the other three (NYFE, KCBT, and ACC) are applicable to governing boards. These rules use various standards. Comex Rule 8.22(a), for instance, limits eligibility for service on the Committee on Business Conduct or on the Supervisory Committee to full exchange members who have not been (i) fined by the Supervisory Committee in the amount of $1,000 or more or (ii) suspended by the Supervisory Committee within the preceding 2 years. Similarly, the CME currently prohibits members found guilty of a major violation from serving on any hearing, disciplinary or pit committee for a period of 2 years from the date of the finding that there was a violation. The other three exchanges generally prohibit currently suspended or disciplined members from serving on their governing boards.

DISCUSSION

Ensuring that exchange members with significant disciplinary records do not serve on exchange disciplinary or oversight panels is sound policy for organizations with substantial self-regulatory responsibilities. The maintenance of such a policy is instrumental to preserving the integrity of the disciplinary process.

It should be possible to assure, through a combination of oversight and rulemaking, that the recent disciplinary history of members does not affect, either in appearance or in fact, the decisionmaking of exchange committees. However, it should be understood that exchanges sanction members for many types of conduct, including decorum violations, failure to comply with membership requirements, violations of capital and customer funds protection requirements, trading abuses related to customer orders, and other trading and market-related abuses. Further, it is desirable for membership organizations to set standards appropriate for self-governance in the first instance.

Therefore, although it is sound policy to bar exchange members with significant disciplinary records for an appropriate length of time from service on exchange disciplinary or oversight panels, a determination would need to be made as to: what is a "significant disciplinary record"; whether the bar to such service should expire after the passage of a certain period of time; what time period should be specified; and whether such a bar should be accomplished directly by Commission rulemaking or by requiring exchanges to set their own disciplinary committee qualification requirements consistent with a uniform guideline or standard.

RECOMMENDATION

The Commission believes that members with significant disciplinary records should be barred for an appropriate period of time from service on exchange disciplinary or oversight panels. A number of exchanges currently have rules prohibiting such service for a certain period of time. The Commission will promulgate rules to address this matter.

PROPOSAL 4: Increasing penalties for trading abuses by, for instance, (i) authorizing the CFTC in egregious cases to fine a violator up to triple the amount of any pecuniary gain resulting from the violation [an approach similar to the SEC "insider trading" statute], or (ii) allowing private parties in egregious cases to sue for punitive damages under the Commodity Exchange Act.

BACKGROUND

The CEA currently authorizes the Commission to bring a civil administrative proceeding against any person who the Commission has reason to believe is violating or has violated the CEA or Commission rules. By way of sanction, the Commission may prohibit such person from trading on a contract market, require all contract markets to refuse such person all trading privileges, suspend or revoke a registrant's registration and impose a civil penalty of up to $100,000 *per violation*. Under Section 22(a) (1) of the CEA, a private party may initiate an action for actual damages to redress a violation of the CEA but is not authorized to seek punitive damages.

The Commission notes that the Securities and Exchange Commission ("SEC") does not currently have the general authority to seek civil money penalties for violations of the federal securities laws.[10] The SEC recently submitted to Congress proposed legislation which, among other things, would authorize the SEC to impose civil penalties of $100,000 per violation except with respect to self-regulatory organizations in administrative proceedings.[11] We are not aware of any civil penalty provision providing an upper limit higher than $100,000 per violation.[12]

DISCUSSION

(i) *Treble Damages*. It is possible that an increase in available civil penalties, like any increase in potential punishment for unlawful acts, may have a deterrent impact upon potential wrongdoers. However, substituting a treble damage provision for the current $ 100,000 per violation civil penalty may not lead to a significant increase in penalties.

Unlike insider trading in the securities markets, trading abuse in futures markets does not necessarily involve large trading profits for a given trader. Wash trades and prearranged trades may be entered into to generate tax losses or make money passes, either in connection with related trading abuses or as part of activities unrelated to the trader's individual futures trading. A trader engaging in such activity may show trading losses that are offset by cash transfers or by tax benefits that may be difficult to identify or quantify. Even where the trading itself results in a gain, the total amount of the gain for an individual may be small.

Finally, where higher penalties are appropriate, it is significant that wrongful conduct under the Act may involve multiple violations. In such instances the Commission can impose penalties in excess of $100,000 and has done so in a number of cases.

Thus, in general, a treble damage penalty as a practical matter may not lead to significantly higher penalties. Moreover, the Commission has not often imposed the maximum penalty per violation, principally due to considerations of the type of offense, proportionality of the fine to the person's assets and other circumstances surrounding the violation (factors required to be considered pursuant to Section 6(d) of the CEA) (see Proposal 12).

(ii) *Private Punitive Damages*. As noted above, a private party may initiate an action for *actual* damages for violations of the CEA, but not for punitive damages. If punitive damages could be awarded in such cases, the deterrent impact of private actions might be increased. In addition, private litigants who might elect not to pursue judicial remedies because of the relatively small size of the anticipated recovery might, in some circumstances, be more likely to litigate if punitive damages were available in addition to compensatory damages.

However, there is always the potential for unfounded or vexatious litigation, a potential. that may be increased if litigants seek damages over and above compensation for losses actually suffered. It should also be noted that punitive damages currently may be sought in certain cases as recovery for violations of state law, such as common law fraud, arising from futures-related transactions. Further, any award of punitive damages would be in addition to possible sanctions imposed for trade practice abuses by exchanges and the Commission.

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[10] The SEC does have such authority in three limited areas: Section 32(b) of the Exchange Act (civil penalty of $100 per day for issuers which fail to file required documents under Section 15(d) of the Exchange Act; Section 21A of the Exchange Act (treble damages against persons trading on inside information); and pursuant to amendments to the Foreign Corrupt Practices Act of 1988, Pub. L. No. 100-418, the SEC may seek a civil money penalty not to exceed $10,000 against an issuer, or an officer, director, employee, agent or stockholder acting on behalf of an issuer, who violates Section 30(a) of the Exchange Act. Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989 (part of legislative proposal transmitted to Congress on January 18, 1989) at 1, n.1 ("SEC Memorandum").

[11] H.R. 975, 101st Cong., 1st Sess. (February 9, 1989) (Sec. 203).

[12] *See also* SEC Memorandum at 8, n.15.

RECOMMENDATION

The Commission believes that penalties should be sufficient to deter abuses. The Commission does not believe that proposals for treble damages and punitive damages would significantly enhance deterrence of violative conduct. As an alternative, the Commission:

(1) Recommends that exchanges review their penalty structures and consider adopting penalty guidelines where appropriate;

(2) Is reviewing its own use of civil penalty sanctions;

(3) As discussed more fully in Proposal 12, recommends that Congress amend Section 6(d) of the Commodity Exchange Act regarding the factors the Commission statutorily is required to consider in assessing civil monetary penalties; and

(4) Also as discussed in Proposal 12, recommends that Congress amend the Act to provide for the automatic suspension of a party's registration and/or trading privileges under the Commodity Exchange Act upon a failure to pay a Commission civil monetary penalty.

PROPOSAL 5: Requiring all broker associations to register and limiting trading among association members.

BACKGROUND

Not all exchanges formally recognize broker associations. Those futures exchanges that do so define broker associations in various ways. The CME has the broadest definition, which includes the following:

(1) Employer/employee associations;

(2) Two or more brokers who share brokerage fees, revenues, expenses, profits and losses; and

(3) Brokers who regularly share a deck of customer orders and/or employee salary expenses.

Other exchanges generally have defined broker associations in terms of ownership or employment relationships. For example, NYMEX, Comex, CSC and NYFE only define as broker associations affiliated brokers such as:

(1) Employer and employee;

(2) Employees of the same employer;

(3) Partners of a partnership; and

(4) Officers, directors and 10-percent shareholders of the same corporation.

Brokers associate with each other to improve their ability to achieve common business purposes. For example, an independent broker who executes customer orders for FCM's may be able to provide a broader array of brokerage services, both within and across markets, in a more economical and effective manner by affiliating with other independent brokers. Broker associations may be better capitalized than a single broker and therefore may be better able to meet any financial responsibility for errors or outtrades. An association facilitates its members allocating the total "decks" of customer orders among association brokers, which can result in more efficient brokerage and improved order executions.

At present, only the CME places limits on broker association trading activity. The CME limits association members' monthly trading opposite other members to 15 percent of total contracts traded for their personal accounts and 25 percent for customer orders. These limits generally pertain to the lead months of the more heavily-traded contracts. CME broker association rules also permit the Exchange to hold an association principal liable financially in a disciplinary proceeding for the conduct of other association members.

NYMEX, Comex, CSC and NYFE consider trades between affiliated brokers to be cross trades. Such trades are required to be executed in accordance with cross trade rules which require, among other things, that the trades are first bid and offered by open outcry and are witnessed by an exchange employee.[13] As is the case with cross trades generally, such trades are specially identified on exchange and member records. Comex limits trades between affiliated brokers in that it does not permit cross trades between one broker's personal account or a house account on one side and a customer account handled by an affiliated broker on the other side. Although the NYMEX, CSC and NYFE place no trading limits on affiliated brokers, their trading activity, as in the case of Comex, is monitored in the course of the cross trade reviews by the respective exchanges.

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[13] *See* NYMEX Rule 6.42(C), Comex Rule 4.24(a), CSC Rule 3.03(c), and NYFE Rules §§ 419 and 420.

To permit careful monitoring of the trading activity of broker associations for noncompetitive trading abuses, and effective surveillance of trading in general, an exchange should be able to identify all broker associations that function on its floor to permit particularized review of their trading through record surveillance. The CME accomplishes this by requiring each broker association to register with the Exchange and to provide such current data as the name of the association, and the names and account numbers of its members. Comex also requires all affiliated brokers to be registered with the Exchange, while NYMEX currently is considering such a measure. Also, as noted above, the exchanges which require trades between affiliated brokers to be executed as cross trades thereby are able to identify and monitor such trading.

The Commission is seeking additional information from all exchanges on the issues of broker association registration and trading restrictions. In letters from the Division of Trading and Markets to all exchanges on February 7 and 8, 1989, the exchanges were asked specifically to consider these issues as part of their internal evaluations of their self-regulatory programs prompted by reports of the undercover investigation in Chicago and in accordance with their legal obligation to monitor their markets.

Discussion

Repeated trading among the same members to the exclusion of other members may be indicative of noncompetitive trading activity, regardless of whether the members trading with each other are affiliated. When such repeated trading involves customer orders, there is the potential that customers may not receive the best executions.

The ability to identify broker associations through required registration and other audit trail indicators would aid in the surveillance of their trading for abuses. Exchange implementation of limits on the trading of association members with each other may also be helpful in ensuring the quality of order execution and market integrity. Any such restrictions should assess how legitimate business activity could be affected. In that connection, inter-broker relationships may be useful for allocating by specialty and availability "decks" of customer orders and increasing capitalization of members responsible for executing customer orders. Such associations may also permit more participants to enter the markets which may result in more efficient executions in some cases.

Recommendation

The Commission needs more information on broker associations from all exchanges before it can make recommendations for changes to exchange rules, Commission rules, or the Act. This additional information is needed in order to assess, among other issues, the appropriate definition of broker associations and the advisability of requiring exchange registration of such groups and imposing limits on broker associations and intra-broker association trading. The Commission has made these issues a high priority on its agenda, asking each exchange to address them and conducting a study of current exchange rules and practices.

PROPOSAL 6: Curbing dual trading in any pits where the exchange audit trail cannot demonstrate a one-minute accuracy rate of, say, 90 percent or better, and where liquidity is already adequate to fill customer orders efficiently.

Background

Dual trading is the practice which permits a broker to execute futures transactions both for customer orders and for his own account in the same market during the same trading session. Dual trading serves as a means of encouraging traders, in markets which do not have specialists or market makers, to provide liquidity to the futures markets. There are prohibitions against brokers trading ahead of customer orders, disclosing orders, or otherwise taking advantage of customer orders designed to prevent customer abuses which could result from the ability of brokers to dual trade.[14]

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[14] In securities markets, dual trading on exchange floors is not permitted for certain classes of members. Each day a securities floor broker must determine whether he is trading for his own

Continued

The Commission has an obligation under Section 4j of the CEA to address periodically whether dual trading should be permitted and to set the terms, conditions, and circumstances under which such trading should be conducted. This section specifically provides that the Commission's analysis should take into account the effect of dual trading upon the liquidity of trading in each market.

In the past the Commission has taken the position that if audit trails could be made sufficient to detect and deter dual trading abuses adequately, dual trading could be permitted to continue.[15] On January 14, 1986, the Commission approved amendments to Commission Regulation 1.35 which require, among other things, that a one-minute time of execution be obtained for every trade. All exchanges implemented systems to fulfill this requirement by December 1987.

The Commission is currently assessing the effectiveness of each exchange's audit trail system. Six of the exchanges reviewed appear to have the ability to achieve a level of accuracy of one-minute execution times of 85 percent or better.[16] The CBT and its affiliated exchanges (the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange), which use the same audit trail system, have not implemented a program to assess the accuracy of trade timing data derived in their system. The Division of Trading and Markets recommended that the CBT develop such a program and the CBT has indicated that it will do so. In any event, most markets are achieving better compliance with the improved trade timing requirement than with prior bracketing systems.

The Commission is in the process of obtaining both audit trail and dual trading information to determine whether particular dual trading limitations, in addition to further improved audit trail data, are necessary. The inquiry includes seeking information from (1) the exchanges,[17] (2) the brokerage community,[18] and (3) the Commission's own data base. Any relevant data that become available from the undercover investigation in Chicago also will be evaluated.

DISCUSSION

An accurate audit trail based on one-minute execution times permits the identification of trade practice abuses, including those associated with dual trading, and materially assists in rendering the investigation of such abuses more expeditious. Of course, verification of the accuracy of one-minute times and of audit trail source records, such as order tickets and trading cards, is essential to such a record being used to the fullest extent possible to address those abuses capable of detection by record surveillance.

Audit trail improvements to date have greatly enhanced surveillance capabilities from what they were under the prior 30-minute bracketing requirement. Significant additional improvements can be made within existing audit trail systems. In this connection, we have requested, among other things, that each exchange establish timetables for achieving specified improved accuracy levels and assure that adequate procedures and enforcement mechanisms are in place to detect and sanction the alteration or fabrication of source documents.

Of course, further improvements could be made to surveillance for dual trading abuses during times of particularly high volume or volatility. In this connection, we have also asked the exchanges to review whether existing systems could be enhanced to provide better records for periods such as the open and the close and during fast markets, when one-minute times may not be sufficiently precise for surveillance purposes.

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account or for the account of a customer at the same trading post. Generally, only specialists are allowed to trade both for their own account and for customers' accounts on the same day. If an exchange member wishes to have an order executed for his own account, then he must follow securities regulations and exchange rules. For example, when NYSE members have orders executed for their own account and these orders are processed through the members' own firms, then they must be labelled as a member's order and must yield parity, priority, and precedent to customers' orders. NYSE members do not have to yield to customers' orders when they have certain brokers who are not affiliated with the member's firm execute their orders.

[15] *See A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Non-public Information, Submitted to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition and Forestry of the Senate,* CFTC, September 1984.

[16] Those six exchanges are CME, Comex, NYCE, KCBT, MGE and NYMEX.

[17] *See* letter dated March 8, 1989, from the Division of Trading and Markets to all exchanges. *See also* Division letters to the exchanges dated February 7 and 8, 1989, which raise a wide range of issues for exchange consideration in evaluation of their self-regulatory programs.

[18] *See* letter from the Division of Trading and Markets to the Futures Industry Association ("FIA") dated March 10, 1989.

Although effective audit trail systems are essential to the detection and deterrence of dual trading abuses, even a real time audit trail will not eliminate the possibility that such abuses may occur, particularly to the extent that they are isolated occurrences or they occur off the floor. Therefore, it has been suggested that eliminating dual trading may be the only way to reduce the potential for certain trading abuses and eliminate certain perceptions of conflicts of interest. However, restrictions on dual trading used in other markets, such as the securities markets, would not eliminate abuses accomplished through accommodating traders.

The Act requires the Commission to consider the impact on liquidity as a condition of any restraints it might place on dual trading. In certain markets and in certain months and during particular time periods and market conditions dual trading may provide an essential contribution to liquidity, which supports fair pricing for customers.

Because the application of additional exchange resources to compliance programs and audit trail systems can improve detection and prevention of a wide range of trade practice abuses, including dual trading abuses, the costs and benefits of improving audit trails further should be considered in conjunction with the costs and benefits of limiting dual trading. The evaluation that the Commission currently is undertaking will look at audit trails and dual trading, will assess several alternatives and may recommend more than one approach and/or different approaches for different markets.

RECOMMENDATION

The Act requires the Commission to address dual trading periodically. The improvements in exchange audit trails mandated by the Commission in 1986 and improvements in Commission data processing capabilities permit us to study dual trading more effectively and efficiently than in the past. In its study, the Commission will address the extent to which dual trading should be limited based on audit trail efficacy and on liquidity, or whether other actions, either statutory or regulatory, are appropriate. Although it would be premature at this time to make a recommendation regarding dual trading for all markets, the Commission supports continued improvement in monitoring dual traders, including further enhancements to audit trail systems. However, absent sufficient oversight by the exchanges and evidence of sufficient justification for the practice, the Commission will undertake rulemaking to limit such trading.

PROPOSAL 7: Mandating improvements in exchange audit trails under CFTC rule 1.35, including perhaps narrowing the one-minute standard to a smaller time increment.

BACKGROUND

The Commission long has been concerned about the establishment of effective exchange audit trail systems. This concern led to the January 14, 1986 approval of amendments to Regulation 1.35 to narrow the trade timing standard from 30 minutes to 1 minute. In setting this new performance standard the Commission found that, based on then-available information, one-minute timing would materially improve existing systems, and that compliance with a more rigorous standard might raise costs beyond attainable benefits.

As of July 1987, most exchanges had implemented audit trail systems which were intended to meet the one-minute timing standard. (The CSC implemented its audit trail system in December 1987.)

Exchanges currently obtain one-minute trade execution times for all trades by one of three methods. The CBT, CME, and CSC all use computerized audit trail systems which impute times through an iterative process. The NYMEX, PBOT, and ACC employ systems in which every trade is time-stamped by the exchange. The remaining exchanges require their members to record one-minute trade execution times manually on trading cards.

The Division of Trading and Markets has completed initial reviews of nine exchange audit trail systems, covering 95 percent of all trading, and has found that each exchange generally has developed adequate audit trail procedures. However, the Division has recommended various enhancements to these systems, including recommendations that the exchanges develop methods:

(1) To improve or maintain a high level of verifiable execution times;

(2) To improve or implement techniques for verifying the accuracy of one-minute execution times and of underlying trade records to reduce the prospect that audit trail source data could be altered, eliminated, or inserted after the fact; and

(3) To identify and sanction noncompliance with audit trail requirements.

The exchanges have responded positively to these recommendations and, on their own initiative, certain exchanges have implemented additional refinements to their systems, such as requiring more frequent trade data submissions, which also may lead to improvements in matching and clearing. Thus, the Commission's oversight activities have fostered continued improvement of trade timing accuracy under the one-minute performance standard, and audit trail improvements, including exchange assessment of new technologies, continue to be a focus of oversight.[19]

DISCUSSION

To date, one-minute trade timing data have proven to be very useful to the Commission and the exchanges for surveillance and trade reconstruction. The ability of computer-assisted trade practice surveillance systems to operate effectively has been improved greatly by one-minute timing data. The ability to use these systems to detect potential trading abuses provides enormous time-savings to exchange and Commission staff in the identification and investigating of trading abuses. Continued improvement in the accuracy of one-minute trade times should further aid these activities.

Although a trade timing requirement of less than one minute could aid trade practice surveillance, it is not clear to what extent it would improve the current quality of surveillance. Moreover, it is uncertain what the costs to the exchanges would be to implement this increased level of precision. It is unlikely that the audit trail systems now in place could be used to capture accurate times of less than one minute. For example, it may be difficult for existing computerized systems to verify achievement of that improved level of precision without significantly increasing the amount of data collected by the exchanges for processing using computer system logic.

Therefore, it is possible that exchange resources which would be committed to reducing the one-minute performance standard could be better used to enhance accuracy and verifiability, and to improve computer-assisted and other compliance capabilities. To the extent resources are directed to narrowing the one-minute trade timing standard, they would not be available for other purposes which may better improve overall compliance efforts. The Commission is, however, actively reviewing how procedures and records for the open and close of trading and other time periods could be improved. Further, new electronic systems such as Globex will test, with actual trading data, the capability of electronic systems to provide a real time audit trail.

RECOMMENDATION

Both the Commission and the exchanges are studying how to improve compliance with current audit trail requirements. Part of that study includes the costs and benefits of obtaining accurate, verifiable trade execution times of less than one-minute. Pending the completion of these ongoing studies, the Commission does not recommend mandating the narrowing of the one-minute standard through regulatory or statutory changes.

PROPOSAL 8: Increasing the physical presence of CFTC or exchange compliance staff on exchange trading floors.

BACKGROUND

The Commission and all futures exchanges have, as part of their trade practice surveillance programs, floor surveillance procedures whereby staff members directly monitor floor trading activity. Generally, exchange compliance staff assign investigators to be present on the floor at the open and close of contracts, and at random periods throughout the trading day. The CME and NYCE currently maintain a continuous presence on their floors. In the course of routine surveillance, these investigators monitor trading and maintain floor surveillance logs. The Commission monitors these logs and exchange floor surveillance procedures via rule enforcement reviews.

Floor surveillance also may be used to note any suspicious activity of specific members in the course of a trade practice investigation and thus confirm initial patterns of suspicious trading activity detected by off-floor record surveillance. Exchange pit committees, which also have floor surveillance responsibilities, also monitor trading and, in the case of on-the-spot disputes or aberrant trades, may take summary action.

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[19] Notably, some exchanges, including the CBT and CME, plan to implement electronic order routing systems. Those systems may result in more timely order executions and improved order and trade documentation.

In the past, the Commission staff has made record surveillance the focus of its trade practice oversight program and has used floor surveillance primarily to keep abreast of how particular markets trade and the physical locations of active traders, and to perform on-site market surveillance at contract expirations and in times of market stress. For example, during the October 1987 market break, Commission staff was present virtually continuously on the floors of the CME, CBT, NYFE and KCBT.

DISCUSSION

Compliance experts disagree on the value of floor surveillance as a mechanism for detecting and deterring abuses. It is not clear what the optimum amount of floor coverage is and to what extent increased coverage would result in increased benefits in terms of detection of trading abuses. Of course, increases in deterrence are not readily susceptible to measurement. Nonetheless, apart from whether increased benefits in the ability to detect and deter trade practice abuses would derive from applying additional resources to floor surveillance, the knowledge that compliance personnel routinely monitor the floor also may have an unquantifiable but positive effect on public confidence that the markets are monitored properly.

Much that can be observed on the floor may be ambiguous such that investigation of the records and other investigative techniques must be used to substantiate whether or not the observed trading was violative. In addition, one investigator using computer-assisted techniques can review more trading and possibly can identify relationships between traders not discernible through floor surveillance. For these reasons, record surveillance generally has been regarded as a more efficient means of covering all the markets the Commission and the respective exchanges must regulate.

RECOMMENDATION

The Commission supports increasing the physical presence of exchange compliance staff on exchange trading floors. The Commission also supports an increased presence of its staff on exchange floors, and given its current resource limitations, is reviewing whether current resource allocations can be changed to permit an increased floor presence without adversely affecting other programs.

PROPOSAL 9: Barring oral orders on the floor and narrowing the price range during market openings and closings.

BARRING ORAL ORDERS ON THE FLOOR

BACKGROUND

Oral orders are orders received from other members on the floor (CTI 3 trades) which are not recorded on order tickets. Oral orders are not so-called "flashed orders," which are orders for which there is an order ticket but for which the terms are hand-signalled to the broker in the pit for execution.[20] Commission Regulation 1.35(a-1) currently requires that an order ticket need not be prepared for CTI 3 trades *if* the broker receiving and executing such order immediately upon execution notes the time of execution to the nearest minute on his trading card or other record. Otherwise, a written order ticket with entry and exit time stamps must be prepared.

The requirement that the execution of orders for which no order ticket is prepared be timed to the nearest minute is intended to ensure that there is an adequate record of such orders to reconstruct trading. In its initial reviews of exchange audit trail systems, the Division of Trading and Markets found an unacceptable level of compliance with the one-minute timing requirement for verbal orders at certain exchanges and has recommended improvements in exchange programs designed to ensure compliance with exchange rules regarding these orders.[21]

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[20] The requirement that an order ticket be prepared for all orders would not impact the practice of flashing orders because there already is an order ticket prepared at the order desk and appropriately timestamped, although the order ticket may not be transferred to the broker in the pit before the order is executed.

DISCUSSION

The purpose behind permitting oral orders on exchange floors is to permit improved efficiency on the part of floor members in executing orders. For instance, a member executing a spread between the soybean and soybean oil pit cannot be in both places at the same time, and may not be able to execute the spread efficiently (*i.e.*, trade at a desired price) if he must move from pit to pit. Thus, in certain circumstances, oral orders may improve member and market efficiency.

However, CTI 3 orders, like other types of orders, can be abused or used to commit abuses. The absence of adequate timing data for verbal orders makes it difficult to sequence or reconstruct such trades accurately, and there may be no other record against which such trades can be effectively reconciled or verified. Thus, detection and prosecution of trading abuses committed by using CTI 3 verbal orders can be very difficult.

As noted above, the Commission has found that certain exchanges have inadequate compliance programs regarding verbal CTI 3 trades, and has recommended improvements in those programs. Separately, the Commission is considering what changes in CTI 3 order procedures are needed. In this connection, the Division of Trading and Markets sent a letter to the exchanges on February 7 and 8, 1989 raising certain issues for their consideration. These issues included whether trades for another member on the floor should be limited or prohibited, and, for example, whether exchanges uniformly should require that orders be prepared and processed for such trades as if they were customer orders (CTI 4 trades), either with respect to all transactions or only to certain categories of trades.

RECOMMENDATION

The Commission believes that the likely benefits of either improved monitoring or limits on oral orders exceed the costs. The Commission will undertake rulemaking with respect to oral orders.

OPENING AND CLOSING PROCEDURES

BACKGROUND

There are a number of possible approaches to address the frequently large volume and volatile price movements during the opening and closing periods (generally 30 seconds to a few minutes duration) (see also Proposal 12). One approach to the potential for widely divergent prices during the opening or close is to limit the permissible trading range during those periods.[22] Other approaches include the development of single price or average price opening and closing procedures.

DISCUSSION

Trading range limits on the open provide brokers an opportunity to advise their customers of market conditions and may effectively delay the opening of trading. This is consistent with the desire to reduce price volatility during the opening range. In reducing price volatility, such measures also provide financial surveillance benefits.

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[21] The Division addressed compliance with this rule in its rule enforcement reviews of the CBT and CME's CTR systems for assigning one-minute times to trades executed on their markets. At both exchanges, by exchange rule, a broker must manually record the minute of execution for such orders (at the CME if a CTI 3 order is received in writing, the one-minute timestamps on the written order are sufficient). The Division determined, however, that the time of execution was not being entered for all such trades, and that the existing CTR systems were unable to distinguish CTI 3 trades which had a manually recorded time of execution from those which did not. The Division found that this could result in less reliable imputed times of execution for some trades.

At the Comex, KCBT, MGE, NYCE, and NYFE the minute of execution must be recorded manually for all trades, of which CTI 3 trades are just one type. At NYMEX, CTI 3 trades are recorded on pit cards, just like other trades, and are timestamped by the exchange. At the CSC, CTI 3 trades are required to have a manually-recorded time of execution, as are the first trade on a trading card and cross trades.

[22] In this regard, the CME amended its rules following the market break of October 1987 to institute an opening price limit of five index points above or below the previous day's settlement price for the opening range in its S&P 500 stock index futures contract. That limit continues if the lead month is trading limit bid/offered until the contract trades off the limit or until the end of the first 10 minutes of trading. If trading is still at the limit after 10 minutes, trading is halted for 2 minutes.

However, reducing the price range during the open and close may not eliminate the potential for trading abuses; it simply may narrow the range within which those abuses may occur. Thus, reducing the price range may not address potential trade practice abuses during opening and closing trading periods as directly as other measures (single and average price procedures) the Commission is reviewing (see Proposal 12).

RECOMMENDATION

Narrowing the permitted price range during the opening and closing of trading does not appear to address potential trade practice abuses as directly as other measures the Commission is reviewing. The Commission is considering single price and average price opening and closing procedures.

PROPOSAL 10: Adjusting CFTC personnel rules to better attract and keep qualified and experienced attorneys, auditors and other professionals.

BACKGROUND

To fulfill its mission to oversee increasingly complex and sophisticated financial markets, the Commission requires a highly competent staff of attorneys, economists, auditors, accountants, futures trading specialists, investigators, and support staff. Most of these positions require advanced degrees or specialized professional training. In addition, futures trading is a specialized field that is largely not understood by the general public. With the tremendous growth in the volume and diversity of the contracts traded, both nationally and internationally, there is a great demand for trained professionals by the exchanges, brokerage firms and law firms, particularly in the major metropolitan areas where the exchanges and CFTC's offices are located. In addition, the futures industry pays top salaries for its highly specialized employees.

In spite of these factors, the Commission has been able to attract and retain capable and qualified staff. Like all federal agencies, the Commission's job has simply become more difficult. In order to address the challenge of recruiting, the Commission has made creative use of all current hiring mechanisms. The agency has done extensive college recruiting and participated in job fairs; advertised positions widely in business and professional publications in addition to the standard federal job listings; made presentations at seminars and professional meetings where attendees have been encouraged to explore career opportunities at CFTC; used cooperative education agreements with colleges and universities to give students a chance to work at the CFTC while completing their formal education; used delegated hiring authority from the Office of Personnel Management (OPM); implemented all special salary rates made available by OPM; and used advanced step hiring where appropriate. In order to recognize, reward, and retain highly capable staff, the Commission makes generous use of performance bonuses and awards to reward outstanding employee performance. For example, two Commission SES employees received Presidential Rank Awards of $20,000 each in FY 1988.[23]

These techniques generally have been successful in enabling the Commission to attract and retain the staff it requires to develop and maintain an effective oversight and enforcement program. However, as with all federal agencies, the challenge increases as the gap between public and private sector salaries grows. This is particularly true in cities where the Commission's offices are located, *i.e.,* New York, Washington, Chicago and Los Angeles, where the costs of living are among the highest in the country.

In addition, the current federal personnel system requires that candidates hired under the competitive process be certified as qualified by the OPM before they can be hired. As a result, CFTC sometimes loses high caliber candidates to private sector offers while OPM certification is pending.

DISCUSSION

Solutions to these two government-wide problems are being studied and proposed by many different organizations and groups including OPM, the New York Federal

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[23] The Commission's ability to pay such awards has been significantly affected over the years by its level of appropriations and the detrimental effects of across-the-board reductions such as Gramm-Rudman-Hollings sequestrations and pay raises without accompanying supplemental appropriations.

Executive Board, and the National Commission on Public Service headed by Paul Volcker.

One proposed solution initiated by OPM is the "China Lake" pilot program, which provides an agency with the ability to classify and compensate both professional and support staff within broad pay bands. The pay band system allows managers flexibility in determining both initial salary and individual increases based on performance and contribution to the agency's mission. Under the present federal system, the salary that accompanies each promotion is fixed and does not reflect a differentiation in work performance among employees. The pay band system also would provide an agency like the Commission with the ability to determine if a prospective employee meets the qualifications criteria for a position. If the employee meets the criteria, the Commission would be able to hire the individual without going through the more time-consuming OPM certification process.

The conversion to a pay-band system would require a tremendous amount of preparatory work by the agency's Office of Personnel prior to implementation. Every job would need to be rewritten and reclassified, and a system of CFTC classification would have to be established for each type of employee hired by the agency. In addition, the agency would have to have a new performance management plan, including standards for performance appraisal, performance-linked pay, and performance-based promotion and retention actions.

Because individuals at the top of the new broader pay bands would continue to be constrained by the federal salary limits, it is not clear how much impact this solution would have on the ability of the agency to attract and retain highly qualified staff.

Another solution being explored by OPM would provide the Commission with the ability to set salary rates that take into account regional and professional pay differentials. Regional salaries would be set based on surveys of private and public sector salaries conducted by the Commission. This would enable the Commission to set salary levels which would compete more effectively with the private sector and state and local governments in the area.

The ability to establish locality-based salaries for professionals would be particularly useful to an agency like the Commission whose offices are almost exclusively located in high cost-of-living areas. It would also enable the Commission to create special salary rates for specified job series in particular locations, as the FBI did for their New York City agents. Finally, the Commission would be able to compete more effectively with the few government agencies such as the Federal Reserve Board which can pay higher salaries for lawyers, accountants and economists because they are not under the civil service system.

Since both of the pay band and locality-based salary solutions would create a unique salary structure for the Commission, it would be unlikely that it could rely on another agency's payroll system, as it does with the Treasury system today. Consequently, the Commission would have to develop its own payroll system at considerable expense.

A third proposal involves providing the Commission with the authority to offer retention bonuses to professional staff based on experience and performance. This could be used primarily to retain key executives whose sudden departure could seriously harm the effectiveness of the Commission's programs. It is not clear, however, whether a retention bonus can secure a long-term commitment from an employee who has considered leaving the agency.

Two additional proposals would provide the Commission with the ability to increase the number of senior staff. These include providing the Commission with additional Senior Executive Service (SES) slots and by providing the agency with the ability to hire a specified number of highly qualified lawyers, accountants and economists up to Level IV of the executive pay scale for special or limited term projects.

Both of these proposals would enable the Commission to provide more positions at higher levels and higher salaries to attract qualified staff. Additional SES slots would provide more upward mobility for outstanding mid-level professional employees. The second proposal would provide the Commission with the ability to hire high-level staff for special projects at more competitive salaries without affecting the work of existing staff.

Both proposals, however, would require additional staff-years and funding to be added to the Commission's budget. Additionally, special care would have to be taken in implementing the second proposal so as not to create morale problems by bringing in staff from the outside for special projects at higher salaries than those received by qualified existing staff members.

Recommendation

As an alternative to the proposals noted above, the Commission supports efforts to increase the salary ranges for all civil service positions. Rather than an across-the-board increase, however, the Commission recommends that the increase be designed to broaden the pay ranges of the GS, GM and SES levels to include additional steps at higher salary levels.

PROPOSAL 11: Increasing CFTC powers and/or resources.

The Commission has substantial powers under the Commodity Exchange Act to address wrongful trading practices, including the authority to impose $100,000 civil monetary penalties *per violation* of the Act. Indeed, the Securities and Exchange Commission recently proposed legislation intended to afford it some types of authority similar to that already held by the CFTC, *e.g.*, to require reporting by large traders, to take temporary emergency actions, such a trading halts, and to impose civil monetary penalties. Several additional means of addressing potential trade practice abuses are discussed below which require new statutory authority.

The Commission has also requested additional resources for FY 1990. The President's budget for FY 1990 contains a request for $37,399,000 and 545 staff-years for the Commission. Following the submission of the President's budget to Congress, the announcement was made of the undercover investigation of the Chicago markets. Subsequently, in order to address issues that have become a focus of concern, both within and outside the industry, the Commission filed a budget amendment with the Office of Management and Budget for an additional 10 staff-years for contract market oversight and enforcement. This request for $585,000 increases the Commission's FY 1990 budget request to $37,984,000 and 555 staff-years. Of the additional 20 staff-years requested for FY 1990, 12 will be devoted to trade practice surveillance and to the investigation and prosecution of trade practice abuses. The remaining staff-years will be devoted to: expanded market surveillance; intensified financial surveillance, especially during periods of volatile markets; investigation and prosecution of other types of violations such as alleged fraud by registrants; and increased support to all program areas, including recruitment.

The results of the Chicago undercover investigation may provide further information relevant to the Commission's budget and statutory proposals and the Commission is prepared to make such further requests as may be warranted based upon that information.

PROPOSAL 12: Any other proposals which you feel that the Committee should consider in this process.

At this time we have identified the following proposals for consideration.

1. *Deletion or Amendment of Section 6(d) ("Net Worth" Assessment).*

Background

In determining the amount of civil monetary penalties assessed, Section 6(d) of the CEA requires that the Commission consider, in the case of a person whose primary business involves the use of the futures markets, the appropriateness of such penalty to the size of the business of the person charged, the extent of such person's ability to continue in business and the gravity of the violation.[24] In the case of a person whose primary business does not involve the use of the futures markets, Section 6(d) requires the Commission to consider the appropriateness of such penalty to the net worth [25] of the person charged and the gravity of the violation.

One way to increase the actual civil penalties imposed by the Commission in its administrative proceedings would be to delete or make discretionary the requirement in Section 6(d) of the CEA that the Commission, in assessing a penalty, take into account factors such as net worth and ability to continue in business. While such factors may be appropriate for Commission consideration, the existence of these statutory requirements has resulted in litigation over the amount of penalties and has tended to restrict the amount of penalties generally assessed.[26] The net effect of these mandated considerations has been that in some cases the Commission has not imposed the level of penalty which the particular violation may have warranted and in other cases its civil monetary penalties have been reduced or eliminated on appeal.

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[24] Section 6(d) of the Act, 7 U.S.C. § 9a provides, in part: In determining the amount of the money penalty assessed under paragraph (b) of this section, the Commission shall consider, in the case of a person whose primary business involves the use of the commodity futures market—the appropriateness of such penalty to the size of the business of the person charged, the extent of such person's ability to continue in business, and the gravity of the violation; and in the case of a person whose primary business does not involve the use of the commodity futures markets—the appropriateness of such penalty to the net worth of the person charged, and the gravity of the violation. . . .

[25] Consideration of the net worth of an individual is intended in part to assure that the Commission does not assess penalties that are uncollectible. The Commission has stated that "[t]he imposition of a civil monetary penalty should be considered with due regard for its collection." *In the Matter of Nelson, Ghun & Associates*, Docket No. 81-13 (CFTC July 5, 1984), *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,255A.

DISCUSSION

The elimination of required consideration by the Commission of factors that tend to limit the amount of civil monetary penalties imposed may result in increased civil monetary penalties and greater deterrence of violations. In addition, the reduction of factors that must be addressed in the sanctioning process may simplify that process and lessen administrative burdens.

At the same time, the requirement that net worth be taken into account may be said to reflect considerations of fairness and collectibility of debts and that a monetary penalty should not be the equivalent of expulsion from the business. In this connection, we note that similar requirements exist in Section 6b of the Act with respect to monetary penalties that may be imposed against contract markets and their officials under that section.

RECOMMENDATION

The Commission recommends that the Act be amended to delete the requirement of Section 6(d) that the Commission consider net worth and ability to continue in business in determining the amount of civil monetary penalties assessed.

2. *Trading Prohibition and Suspension of Registration for Failure to Pay a Final Civil Monetary Penalty.*

BACKGROUND

The Commission believes that the Act should be amended to provide for an automatic prohibition from trading on all contract markets for any party's failure either to appeal a Commission civil monetary penalty order or to pay the penalty in accordance with the terms of the order. If the party is registered with the Commission, such a failure should also result in the automatic suspension of registration. These provisions would be applied within 15 days from the expiration of the period set for compliance with the penalty order. Such a provision could further provide that if on appeal from the penalty order the Commission prevails or if the appeal is dismissed, the automatic trading prohibition and/or suspension of registration shall become effective upon the expiration of 30 days from the date of judgment on the appeal unless the penalty is paid.

DISCUSSION

This additional authority would enhance the effectiveness of the Commission's civil monetary penalty collection program and discourage registrants and other persons from ignoring Commission orders. This authority would be consistent with Section 14(f) of the Act, which provides for such automatic suspensions upon failure to comply with Commission reparation orders.

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[26] *See, e.g., Gimbel* v. *CFTC*, No. 88-1849 (7th Cir., April 10, 1989), petition for rehearing filed; *In the Matter of Premex*, Docket No. 79-44 (CFTC February 17, 1988), *reprinted in* 2 Comm. Fut. L. Rep. (CCH) ¶ 24,165; *In the Matter of Incomco, Inc.*, Docket No. 80-25 and 82-20 (CFTC July 16, 1987), *reprinted in* 2 Comm. Fut. L. Rep. (CCH) ¶ 23,901; *In the Matter of Nelson, Ghun & Associates, supra.*

RECOMMENDATION

The Commission recommends that the Act be amended to provide for an automatic trading prohibition and, if applicable, the automatic suspension of registration with the Commission upon a failure to appeal from or pay a civil monetary penalty order within 15 days from the expiration of the period fixed for compliance with such order.

3. *Establish Registration Requirement for Floor Traders.*

BACKGROUND

Currently, floor brokers (those who execute trades for others and who may also trade for their own account), but not floor traders (who trade solely for themselves), are required to register under the CEA arid thus are subject to statutory disqualifications based upon backgrounds of criminal convictions, specified civil dispositions (such as fraud or abuse of a fiduciary duty) and other specified matters relevant to fitness. Amending the Act to require the registration of floor traders would assure that applicants with statutory disqualifications under the CEA (or comparable standards) are denied access to trading floors. The amendment would include the creation of a statutory definition of the term "floor trader" and the establishment of a new registration requirement for floor traders.

The CEA's registration categories historically were formulated to require the registration of commodity professionals dealing with customers and/or customer funds to assure their backgrounds are such that they are "fit" to have such dealings. In addition, the CEA's registration framework is designed to permit the Commission, through efficient administrative proceedings, to preclude commodity professionals who violate the Act or otherwise are statutorily disqualified from continuing to transact customer business.

DISCUSSION

Requiring the registration of floor traders may be beneficial because unregistered persons trading for their own accounts may aid floor brokers who are handling customer accounts in the commission of offenses that could affect customers. Registration thus would provide an additional regulatory tool to police those whose actions may indirectly affect customers to the same extent as those who deal directly with customers. Registration of floor traders also would facilitate preventing persons with floor privileges who are sanctioned at one exchange from moving to other exchanges. The requirement that such persons be licensed would provide access to FBI fingerprint checks which are currently part of the registration process. Such procedures ordinarily would not be available to the exchanges as a condition of membership alone.[27]

The Commission would have at least some direct regulatory role under this proposal, including the initiation of adverse actions against floor traders and applicants for registration therefor, since NFA only handles the ministerial paperwork processing for floor broker registrations. Thus, some Commission resources would have to be redirected.

An alternative means of regulating access to trading floors that would not require legislation would be to establish by rule a requirement that the exchanges certify to the Commission the fitness of those granted floor trading privileges. For example, the exchanges could be required to certify that floor traders are not subject to specified criminal convictions or civil dispositions that would constitute statutory disqualifications under the Commodity Exchange Act.

RECOMMENDATION

The Commission recommends that legislation be enacted to establish a statutory definition of and registration requirement for floor traders.

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[27] Two exchanges (Comex and CME) have asked NFA to do such checks and NFA has indicated it would do so provided the exchanges required floor traders to register as floor brokers.

4. *Changes to Opening and Closing Procedures.*

BACKGROUND

Openings and closings of trading are periods in which the fairness of executions has been called into question more frequently than in other trading periods and in which monitoring of executions is particularly difficult because of the large number of transactions in active markets. The Commission is actively reviewing possible modifications to opening and closing procedures and has directed each futures exchange to review its opening and closing procedures to identify possible approaches to address the frequently large volume and volatile price movements during the opening and closing periods (generally 30 seconds to a few minutes duration).

A single price open or close or an average price order procedure may reduce the potential for taking advantage of customer orders. Such systems are designed to ensure that all who participate in the open or close, whether customers or floor traders, either get the same price or can opt for an average price, compared to the uncertainty of a price anywhere in the opening or closing range.

By letters of February 7 and 8, 1989, the Division of Trading and Markets requested that the exchanges address whether a single price open or close or average price order procedure would be useful. The Division also suggested that the exchanges consider whether (1) special recordkeeping should be required for the opening and closing periods, and (2) limitations should be imposed on participation in those trading periods.

Certain exchanges have developed and the Commission has approved, as consistent with the requirements of the Act for competitive execution, special procedures for those periods.[28] For example, the ACC and PBOT have a single price open, the CME's Globex system will use a computer algorithm based on priority of price and time and a formula for establishing a single price, and NYCE has an average price order procedure. In addition, the CSCE requires that members specially identify trades executed during openings as part of its audit trail system. The Commission believes that there may be other innovative procedures and recordkeeping refinements which should also be explored.

DISCUSSION

Average price procedures may generally benefit customers by providing them with the assurance that they will get an "average" execution price compared to the uncertainty of a price anywhere in the opening or closing range. Under the NYCE average price order procedure, the customer must elect to use an average price order. The potential benefit to the customer was borne out by a NYCE study of its average price order procedure during 1986, which was undertaken at the Commission's request. That study indicated that, on average, customer trades executed using the average price order procedure received better prices than those executed at the market price.

It has been suggested that single price opening or average price procedures would be difficult to implement in a large open outcry market. (For example, ACC and PBOT do not have active markets and Globex, an electronic limit order-only system, has yet to be tested.) With a one-price opening it also necessarily follows that some participants may, because of the establishment of a single price, get a less advantageous price than they would if a single price procedure were not employed. Average price order procedures also raise questions of how the price would be determined.

RECOMMENDATION

The Commission is actively reviewing possible modifications to opening and closing procedures and has directed each futures exchange to review its opening and closing procedures to identify possible approaches to address the frequently large volume and volatile price movements during the opening and closing periods.

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[28] In addition, the CME announced on April 19, 1989 a proposal for a special settlement session at the close of trading and to permit certain orders to be netted on the open. On the same day, the CBT announced a proposed one-minute trading session for the end of each trading day for all its futures contracts. Further, the CBT has recently approved, and the CME is evaluating, proposed audit trail enhancements specific to opening and closing trading sessions.

The **Chairman**. Of course. Certainly. We welcome any other ideas you may have. Now is the time to bring the shopping list forward. Then let us see where we go from there.

We will stand in recess. If other Senators have questions, they can be included for the record. Thank you.

Dr. **Gramm**. Thank you.

[Whereupon, at 11:55 a.m., the committee recessed, to reconvene at 9:45 a.m., Wednesday, May 17, 1989, in room SR-332, Russell Senate Office Building.]

[Material submitted for inclusion in the record follows:]

APPENDIX

Box 247,
DORCHESTER, NE, *March 4, 1989.*

Hon. PATRICK J. LEAHY,
Chairman, Senate Agriculture Committee, U.S. Senate, Washington, DC.

DEAR SENATOR LEAHY: I wish to submit this letter as a statement for the record to the Senate Agriculture Committee in its hearings to determine whether the Commodity Futures Trading Commission should be reauthorized for extension of operation. I am a farmer near Dorchester, Nebraska. I presented statements in person and for the record to the House oversight subcommittee on the CFTC in 1978, 1979, 1980 and 1982 and to the Senate Agriculture Committee one time with Senator Helms chairing the hearing. I did not submit testimony at the 1984 hearings when I was serving in the Nebraska Legislature. In all of my previous testimony I addressed the issue of price debilitating speculative short selling allowed on the futures exchanges in contradiction to the mandate of President Franklin Roosevelt and the legislative intent and enactment of the Commodity Exchange Act in 1936. This act was specifically designated in the Congressional Record of June 3, 1935, as an act to limit or abolish speculative short selling. The act contains language to properly effect this goal.

The FBI investigations of the Chicago futures exchanges on point shaving by the traders is in order. Farmers have generally known that dual trading is subject to point shaving. They are also aware of account switching. That is why they decline to participate in futures trading and the expensive options for futures trades which are subject to the same shortcomings of the underlying futures trades. It is questionable why only the Chicago exchanges are being closely investigated.

The part of futures trading that farmers actually object to because it has the primary impact on setting the cash price levels of the commodities they produce and because it is not equitably controlled under provisions of the Commodity Exchange Act is speculative short selling. The CFTC has repudiated and ignored the producers' complaints on this issue and has as recently as 1987 approved expanding the speculative position limits from 3 to 15 million bushels per trader per commodity of grain.

When speculative short selling on a volume that exceeds the annual national production of a commodity is allowed to initiate price setting trades, as is now the case, the farmers know that they have been displaced and excluded from having an effective part to play in negotiating a true price based on supply and demand of the actual commodity. This is archaic and a direct cause of the budgeted deficiency payments under the farm program.

Farmers endorse terminating the CFTC and placing the regulation of commodity futures trading under the Securities Exchange Commission because the SEC operates under a law that specifies that securities cannot be speculatively sold short unless the previous trade transaction had an up-tic to the price. The law states that this provision is to protect the value of the security and the industry that it represents. This change of regulatory commissions would allow the Congressional Agriculture Committees to plan adequate national agricultural production without the farm program budgets being distorted and inflated by speculative price manipulation as has been occurring.

Sincerely,

DON ERET.

[The Knight-Ridder MoneyCenter News No. 11003 follows:]

KRF SPOTLIGHT: CME'S COMMITTEE CHOICES RAISE SELF-POLICING DOUBTS

(By Laurie A. Morse)

Chicago—Mar. 2—KRF—The Chicago Mercantile Exchange's trading floor committees—key cogs in the CME's self-policing efforts—were themselves riddled with traders who were masters at violating trading rules at the time the FBI presumably first infiltrated the pits to examine trading practices in 1986.

The presence of some of the exchange's major offenders on the committees shows that some rule violations had become generally accepted ways of doing business. The situation also brings into question whether U.S. future exchanges have done their best at policing themselves.

Although floor committees are an exchange's first line of defense against trading improprieties, the CME does not prohibit major or repeat rule violators from serving on its policing or disciplinary committees.

Futures exchanges are self-regulatory organizations, meaning the Government allows them to write and enforce their own rules under the scrutiny of a Federal agency, the Commodity Futures Trading Commission. While the larger U.S. exchanges have sophisticated trade monitoring procedures and sizable surveillance staffs, they for the most part depend on members to police each other and, further, to report trading floor abuses.

Trading floor ethics and proper order handling are learned through on-the-job experience, with traders absorbing the methods of their compatriots in the pits.

The CME's "floor broker qualification committee" usually provides a broker's only formal training. The committee administers a program stressing floor broker responsibility in order execution and emphasizing specific rules and situations related to filling customer orders.

Presumably, the traders on that committee should be stellar examples of broker etiquette and ethics. However, the committee's relatively low status at the exchange and the time required of its members make recruiting difficult, CME governors say.

That could be how in 1986 a trader named Michael Patti was among those selected to train rookie brokers. Patti at the time of his selection had a disciplinary record of repeated major rule violations dating back to 1979.

Patti in 1979 was ordered to "cease and desist" from violating the priority of customer orders. In 1980 he received a 2-day suspension and a $2,000 fine for the same rule violation. In 1983 he was found to have prearranged trades in Deutschemark futures and received a 15-day suspension and a $20,000 fine, as well as a cease-and-desist order.

A subsequent disciplinary notice shows he continued to engage in prearranged trading during the time he was on the committee. In 1988, the record shows, he was given another $20,000 fine and a 6-month suspension for improperly resolving outtrades by prearranging trades in Deutschemark futures during 1986.

Patti is no longer a member of the exchange, a CME spokeswoman said, although CME records show he is eligible to reapply assuming he has paid his fines.

Much more powerful CME committees also were dotted with questionable members in 1986.

An example is the CME's agricultural floor practices committee. The committee has the power to investigate and punish trading violations, and its members hold a judiciary role over their colleagues.

In 1986 nearly one-quarter of the CME's agricultural floor practices committee either had already been sanctioned for significant rule violations or would be disciplined during the following 2 years.

The committee at the time included Richard Allison, a floor broker who is a member of the powerful Kaulentis-Kravitz broker group, known formally as ABS Partners. Allison, who remained on the floor practices committee in 1988, was fined $7,500 last year and suspended for 15 days in connection with prearranging Swiss franc futures trades.

James Kaulentis, a partner in the ABS Partners group, was also on the floor practices committee in 1986 despite a 1985 sanction for "conduct detrimental to the dignity or good name of the exchange." The rule violation involved activity in the CME's pork belly pit and brought Kaulentis a $2,500 fine.

William Kulp, another committee member who retained his post in 1988, was fined $2,500 in 1980 for trading ahead of customer orders. Jim Colitz, selected for the floor practices committee in 1986, was fined $2,500 and suspended for 2 days in 1983 for a major rule violation involving live hog futures.

In 1986, floor practices committee member Robert Besner's disciplinary record contained only one 1985 warning of rule violations for improperly resolving trading errors. However, by 1987 Besner had been given a $15,000 fine and a 5-day suspension for taking trades made for a customer into his own account and a $25,000 fine and 15-day suspension for prearranging trades.

Responsibility for committee selection at the exchanges rests with the chairman of the board, who recommends committee selections to the full board of governors for approval.

In 1986, CME Chairman John "Jack" Sandner was in the first year of what was to become a 3-year term. He stepped down this year after serving as long as CME rules allow.

In an interview Wednesday, Sandner acknowledged he was technically responsible for selecting the 1986 committees, but said he delegated most of the task to other members of the Board of Governors.

The CME's process of qualifying brokers for committee service is currently under scrutiny by the CME, Sandner said, and will be addressed by a panel appointed to examine trading practices. Sandner said he followed the CME rulebook to the letter in choosing committees in 1986.

"Whether the rules need to be changed is another question," he said. "We're currently in the process of looking at that very issue."

Gerald Beyer, CME senior vice president for legal and regulatory affairs, said a CME rule currently prevents a member from serving on any hearing, disciplinary or pit committee for a period of 2 years after a major rule violation. However, Beyer said he was uncertain how the rule was phrased in 1986.

Both Beyer and Sandner said it was up to the CME staff to screen ineligible members from committee application lists before the names were given to committee chairmen for consideration.

In any event, the CME's leadership in 1986 approved a pit oversight committee that was to become one of the most notorious in the business. Pit committees deal with day-to-day disputes in the trading pits.

While not the most powerful committees on the exchange, pit committees are important because they touch the fortunes of every trader and customer and possess the ability to negate trades and adjust prices and opening and closing ranges, as well as the responsibility of settling prices every day in every pit.

For years, pit committees at the CME were selected by a single member, Harry Lowrance, who held the title of floor chairman. Lowrance, in 1988, was listed as a member of at least four broker groups, or syndicates, at the CME and is considered by traders to be one of the most powerful members on the floor because of his role and connections.

Lowrance remains floor chairman, but by 1986 he was aided in pit committee selection by three CME governors and three other members.

It was a banner year for stocks and stock index futures in 1986, with index arbitrage coming into its own and volume burgeoning as public customers funneled funds into a bull market.

The S and P 500 pit committee that year oversaw the most volatile futures market in the industry's history at a time when the pit was experiencing unprecedented growth and also was populated by some of the CME's youngest and least-experienced traders.

Despite those unusual conditions and the potential for abuse they presented, at least 6 of the 28 members on the S and P 500 pit committee and significant rule violations on their records, or would prove later to have been engaged in unethical trading practices during or shortly after they served on the committee.

The S and P 500 pit co-vice chairman in 1986 was a CME broker named Glenn Laken. Laken was fined $20,000 by the CME and suspended for 10 days in 1987 for allowing a clerk in his employ to improperly disclose to him another broker's customer orders in the S and P 500 futures pit.

Laken himself escaped disciplinary action in connection with CME and National Futures Association investigations in 1987 of his former business partner, Robert Schillaci.

However, CME traders have repeatedly noted the unusual circumstances surrounding Laken's disciplinary hearing. Laken was acquitted by the CME business conduct committee and a week after the acquittal, the chairman of the committee, Lawrence Rosenberg, went to work as an executive at Laken's brokerage firm.

The S and P 500 futures pit committee in 1986 also included Jeffrey Donnelly, a broker for Chicago Research and Trading. Donnelly is currently completing a prison sentence for fraud stemming from illegal trades he made in S and P 500 futures at the CME from 1984 through 1986.

During his tenure on the pit committee, Donnelly prearranged trades, withheld orders and traded against customer orders, CME disciplinary files show. He was fined $100,000 and expelled from the exchange in 1987.

Other S and P pit committee members who had major trading violations on their records in 1986 were Martin Potter, who was fined $5,000 and given a 5-day suspension in 1982 for prearranged trading, and Steven Dorn, who was fined $1,000 in 1981 for trading against customer orders in the opening ranges of IMM T-bill futures. Dorn remained on the pit committee in 1988.

Jerry Friedman, another broker on the S and P committee that year, was fined $12,000 for prearranging S and P 500 futures trades in October 1987.

A sixth pit committee member also had a disciplinary action in his file at the time he was appointed. Broker James Place was fined $5,000 for 1983 trades in the CME's pork belly pit that were deemed "damaging to the welfare of the exchange."

Place, who remained on the S and P pit committee in 1988, had another brush with rule violations last year when a runner in his employ was found to have participated in allocating "to a member's personal trading account purchases and sales that had been non-competitively transacted against customer orders," the CME said.

Although many industry leaders are advocates of floor broker self-policing, the lack of qualifying criteria for committee selection can leave the proverbial fox in charge of guarding the chicken coop, they say.

Banning major or repeat rule offenders from committee service, particularly from pit and judiciary committees, could serve as a deterrent for some brokers, CME traders say. Many brokers who fill large numbers of customer orders see it as in their best interest to be on those committees, the traders say, even though committee service can be time consuming and otherwise burdensome.

The CME recently elected a new chairman, John Geldermann. He and the Board of Governors this week are in the process of forming new exchange committees for 1989.

OVERSIGHT HEARINGS WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Trading Practices in the Commodity Futures Markets

WEDNESDAY, MAY 17, 1989

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:45 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Heflin, Conrad, Daschle, Baucus, Kerrey, Cochran, Boschwitz, Bond, and Gorton.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. We will come to order. And gentlemen, if you would come forward, please.

I might announce at the beginning, just to make it easier—and this will be highly concurred in by Senator Baucus, the newest member of our committee——

Senator BAUCUS. Second-newest.

The CHAIRMAN. Second-newest member of our committee; new this year, but not a new Member of the Senate. He is a senior member of the Finance Committee, and it is a great help to us on the Agriculture Committee having you here, Max.

When we go to the questions, after Senator Lugar and I have gone through our questions, we will take questions in the order that Senators are here. And this is a rule that we will start following in future hearings this year. We are getting into a time when every Senator has four or five committee meetings going on at the same time, and it is the only way we are going to have Senators be able to determine when they can go.

So, after Senator Lugar and I, it will be Senator Baucus, and then in the order in which Senators appear. You do not mind that rule; do you, Max?

Senator BAUCUS. I commend the Chairman on his wisdom. [Laughter.]

The CHAIRMAN. This morning, we continue our oversight inquiry into trading practices in the commodity futures markets. Our witnesses are heads of the four largest U.S. futures exchanges: the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Mercantile Exchange, and the Commodity Exchange, Inc. Altogether, more than 90 percent of all U.S. futures trades take place on the floors of these four markets covering such vital commodities as energy, U.S. currency values, Government debt, precious metals, corporate stock indices, and agricultural produce.

Last January, the criminal probe of the Chicago exchanges turned a public spotlight on these markets, and specifically how well they police trading practices on their floors. Since that time, additional factors have heightened this concern: The General Accounting Office has questioned the "intensity" of exchange and CFTC efforts to detect and punish trading abuses. The CFTC has issued critical reports on some exchange enforcement programs, and questions have been raised as to whether the CFTC itself has the resources to do its own oversight job effectively.

Finally, 2 weeks ago, the CFTC unveiled an enforcement initiative, conducted with Postal inspectors and U.S. Attorneys, aimed at the futures markets in New York. Reportedly, as with Chicago, the New York probe involves possible trading abuse on exchange floors.

Under traditional self-regulation, futures exchanges have the "front line" responsibility to keep their own houses clean, subject to oversight by the CFTC. The principal question before us, then, is whether you, as the exchanges, have been tough enough in policing your members, detecting and punishing those who break the rules?

If the answer is "no," or "maybe," then we have a very serious problem on our hands, and Congress will be compelled to step in with appropriate actions.

Each of the exchanges here today has taken steps since mid-January to improve trading practices under its roof, and I commend these contributions to the public debate. I expect that we will have ample opportunity today to discuss your ideas.

I thank the witnesses for their preparations for today's hearings, and we look forward to your testimony.

Senator Baucus, did you have anything you wanted to say?

Senator BAUCUS. I have no statement. Thank you.

The CHAIRMAN. Then we will go in this order. We will hear first from Leo Melamed, chairman, of the executive committee of the Chicago Mercantile Exchange; and then Karsten Mahlmann, the chairman of the Chicago Board of Trade; Lou Guttman, the chairman of the New York Mercantile Exchange, and Robert Fink, the first vice chairman of the Commodity Exchange of New York.

So Mr. Melamed, you get the chance to lead off. And without objection, the opening statement and questions of Senator Lugar will be made part of the record.

[The prepared material of Senator Leahy and the prepared statements of Senators Lugar, Conrad, Kerrey, and Boschwitz follow:]

FUTURES VOLUME HIGHLIGHTS

1988 IN COMPARISON WITH 1987

		1988		1987		
RANK	EXCHANGE	CONTRACTS	%	CONTRACTS	%	RANK
1.	Chicago Board of Trade	116,758,862	47.49%	101,626,958	44.40%	(1)
2.	Chicago Mercantile Exchange	65,662,682	26.71%	71,334,072	31.17%	(2)
3.	New York Mercantile Exchange	28,710,105	11.68%	22,474,629	9.82%	(3)
4.	Commodity Exchange	16,277,050	6.62%	17,884,617	7.81%	(4)
5.	Coffee Sugar & Cocoa Exchange	8,322,606	3.38%	5,784,383	2.53%	(5)
6.	MidAmerica Commodity Exchange	3,370,732	1.37%	2,350,692	1.03%	(8)
7.	New York Cotton Exchange	2,988,379	1.22%	2,498,014	1.09%	(7)
8.	New York Futures Exchange	1,874,715	0.76%	3,069,125	1.34%	(6)
9.	Kansas City Board of Trade	1,432,754	0.58%	1,505,103	0.66%	(9)
10.	Minneapolis Grain Exchange	425,778	0.17%	317,977	0.14%	(10)
11.	Chicago Rice & Cotton Exchange	47,627	0.02%	31,114	0.01%	(11)
	TOTAL	245,871,290	100.00%	228,876,684	100.00%	

Source: Futures Industry Association

Monetary Sanctions Imposed by Exchanges for Trade Practice Violations

1986 - 1988 */

	1986	1987	1988
CBT	$180,500	190,100	287,000
CME	$285,400	2,098,925 */	717,250
COMEX	$441,450	580,200	592,500
NYMEX	$ 95,000	0	32,500
CSC	$147,275	63,925	47,500
NYCE	$ 23,550	9,225	1,400
NYFE	$ 23,125	6,750	72,022
KCBT	$ 65,000	13,500	1,500
MACE	$ 400	0	0

Source: Commodity Futures Trading Commission

GAO Disciplinary Actions

The Chicago Mercantile Exchange	CY84	CY85	CY86	CY87	CY88
Floor Participants Sanctioned	13	60	43	69	105
Fines	$155,275	$630,800	$313,500	$1,715,675	$811,250
Expulsions	1	1	0	8	2
Suspensions (Bus./Cal. days)	570	6,368	238	12,392	6,110
The Chicago Board of Trade					
Floor Participants Sanctioned	12	8	32	26	13
Fines	$175,000	$225,000	$203,200	$64,500	$143,500
Expulsions	4	2	3	1	0
Suspensions (Business days)	55	539	5,587	166	4,339

EXCHANGE COMPLIANCE STAFFS

Figures generally include staff who have direct duties in the Compliance Department, e.g., trade practice, audit trail, financial audits, market surveillance, and legal and computer staff.

Chicago Board of Trade	1980	1982	1984	1986	1988
Compliance Staff	44	48	70	78	83
Chicago Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Staff	32	37	40	60	89
Commodity Exchange, Inc.	1980	1982	1984	1986	1988
Compliance Staff	24	34	39	29 11/	33
New York Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Staff	11	15	20	18	33

Source: Commodity Futures Trading Commission

Prepared Statement of Hon. Richard G. Lugar, a U.S. Senator From Indiana

COMMODITY EXCHANGE ACT REAUTHORIZATION—EXCHANGE TRADING PRACTICES HEARING, MAY 17, 1989

Good morning Mr. Chairman. I am pleased to be here this morning and particularly look forward to hearing the statements and responses to questions by this panel of exchange witnesses. But, before I comment on what is about to come today let me take just a moment to assess where we are and what has transpired so far this year.

In January, I was prepared to launch the Commodity Exchange Act reauthorization effort with the introduction of a very short and simple bill, which would have done little more than extend the authorization period for 5 years and respond to two changes in the law requested by the Commodity Futures Trading Commission. However, with the revelation of the massive FBI investigation of the Chicago futures exchanges that hit the press on January 19, it became apparent that the simple reauthorization approach would probably not be appropriate. Now similar reports have hit the press regarding an investigation of the New York exchanges, so it appears that my intuition was correct.

Instead, Chairman Leahy and I, along with other members of the committee have undertaken to collect information and to try and evaluate just what the situation is in the futures trading industry. Despite our best efforts, we still have not even a clue of the specific activity that is the target of the ongoing criminal investigations, which is critical to our ability to evaluate and judge the effectiveness of the current system.

In any event, in February, the committee held its first hearing during which we heard testimony from the GAO to the effect that a wide range on trade practice abuses are taking place on the exchange floors, but that the systems in place to detect and sanction them have many deficiencies. The GAO also presented us with data showing what appeared to be widely diverse approaches among the various exchanges to the enforcement of their trading rules.

Not long after we heard from the GAO, the Chairman of the CFTC came before the committee on March 9, and testified as to the results of the agency's recent rule enforcement reviews of several exchanges. Striking about this testimony was the extent to which it raised questions about the effectiveness of the surveillance process in detecting and preventing trade practice abuses at some exchanges.

Despite these problems, the industry has continued to defend the current regulatory system and maintained that it is the most effective system available. One of the bright lights in this process is the extensive efforts that have now been undertaken across the futures industry to perform a self-evaluation of the regulatory process and to look at refinements and adjustments to it that can and should be made by the exchanges without any action on the part of Congress. I want to applaud you for these efforts, but I reserve judgment on them until your efforts are further developed and broadly implemented.

At this point in the process, I firmly believe that the committee still needs a great deal of additional information before it will be in a good place to determine to what extent the Commodity Exchange Act needs to be amended by Congress to ensure an effective regulatory system. One thing I am sure of is that there is a strong public perception that the exchanges are not effectively regulated and that the Congress should act. This I suspect has a great deal to do with the prominent calls by Congressman English for a complete revamping of the Act.

The task for our witnesses here this morning is to describe clearly and objectively for us the state of their regulatory systems and their commitment to ensuring public confidence in the futures industry. I would like to hear specifically what their ongoing evaluations of the surveillance and audit trail systems have revealed and what they plan to do to deal with any deficiencies they have found. I am aware of a number of different opinions on several issues that are emerging from the current self evaluatory efforts—such as dual trading; penalties; broker associations—so I want to know how this industry plans to coordinate and come up with appropriate industrywide standards for grade practice enforcement. Is it the view of the witnesses that the committee will have to sort through the various proposals and impose reforms on its own through legislation? Finally, I am most interested in the views of the witnesses on the entire issue of electronic trading and what role it may have in helping to deal with the problem of trade practice abuses or the perception thereof.

I don't want to end on what sounds like a sour note, so let me just say that I have been a strong supporter of the current self-regulatory system and I have no information at this time that leads me to abandon that support. However, there is clearly a problem in the industry that needs to be dealt with in order to establish, or reestablish as the case may be, confidence in the system and in the industry as a whole. I hope these witnesses will shed some bright light on this challenge.

Thank you Mr. Chairman.

PREPARED STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

OPENING STATEMENT, HEARING ON COMMODITIES FUTURES MARKETS, SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY, U.S. SENATE, MAY 17, 1989

Chairman Leahy, I am pleased that you are continuing to hold hearings on the commodities futures markets and I welcome the testimony of our distinguished witnesses today. I hope we can all work together to restore confidence in all the commodities futures markets. That confidence has been severely tested by the highly publicized investigations of trading practices in some of the markets.

The commodities futures markets are essential management tools for farmers, businessmen, processors, and traders of agricultural and other commodities. If we had no futures markets or poorly functioning ones, all participants in the commodity marketing chain would face a far more risky business environment. Recent revelations of illegal and unethical trading practices have severely undermined the confidence of many in the futures markets. The need for some kind of reform is clear to this committee and to the industry itself.

I welcome the efforts of the commodities futures industry to expand and improve its own procedures to detect fraud and illegal practices. There is no question that improved self-regulation is needed; however, are industry self-generated reforms enough? Clearly, they have not been enough in the past. The questions the Congress faces are twofold. First, is there a need for revised rules for the industry regarding trading practices and procedures? Second, what can be done to tighten government oversight and regulation of the self-regulation efforts of the industry? In other words, how can the federal regulators better monitor and interact with, the self-regulation efforts of the industry? I hope these hearings will help answer these questions. I look forward to the testimony of our industry representatives.

PREPARED STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Mr. Chairman, since the committee last met on this issue, I have learned that of the $24.7 million in monetary penalties imposed by the CFTC since fiscal year 1976, over one-half—$12.7 million—remains uncollected.

Under current policy, the CFTC refers unpaid fines to the Department of Justice for collection. Right now nearly $4 million in unpaid fines remains pending at Justice. Many of these individual fines equal $100,000 or more.

On April 7th I wrote to the Attorney General to ask for an explanation as to why the Department of Justice has apparently been so lax about collecting these penalties. I was told yesterday that I should be receiving a response to my letter shortly.

Mr. Chairman, I would like to include in the record this morning a copy of my letter to the Attorney General as well information provided by the CFTC which details the individual name and dollar figure for each outstanding penalty.

I bring this information to the committee's attention because I believe we need to be concerned not only about the detection of fraud in the futures industry, but the full prosecution of that fraud. Right now we are sending a message to the swindlers and the crooks that the odds are on their side—that they can escape a CFTC fine even if they are caught.

I think the Federal Government should pursue fraud in the commodities markets with at least the same vengeance that it goes after unpaid student loans or the overpayment of advanced deficiency payments to my corn farmers.

I should note that there may be some cause for hope. In a memorandum to the Commission dated April 19th, the Director of the CFTC's Division of Trading and Markets noted that "the Division is establishing a system whereby all delinquent debts will be reported to one or more credit reporting agencies."

Also, just recently the Department of Justice agreed with a CFTC request to offset unpaid fines against any future income tax refund that may be due an individual. I can only wonder why—after 10 years and $12.7 million in delinquent fines—these basic steps are just now being taken.

[Attachments follow:]

U.S. SENATE,
WASHINGTON, DC, APRIL 7, 1989.

The Honorable RICHARD THORNBURGH,
Attorney General of the United States, U.S. Department of Justice, Constitution Avenue and Tenth St., NW., Washington, DC.

DEAR MR. ATTORNEY GENERAL: As a member of the Senate Committees on Appropriations and Agriculture I have been involved in congressional efforts to monitor the current investigation of the Chicago futures exchanges being conducted by the U.S. Attorney in Chicago, the Federal Bureau of Investigation, and the Commodity Futures Trading Commission (CFTC).

In the course of following the investigation I have learned that when the CFTC finds that it is unable to collect monetary penalties assessed against those who have violated the Commodity Exchange Act, it refers those cases to the Department of Justice for collection.

I have also learned that there are a number of such cases outstanding and that, apparently, the Department of Justice has a policy of not pursuing collections involving penalties below some arbitrary amount.

I am enclosing for your review a list of outstanding CFTC penalties that, I am told, were pending at the Department of Justice as of September 30, 1988. The list includes some penalties several years old and many in amounts of $100,000 or more. It is my understanding that the CFTC will be forwarding 17 additional such claims to you in the near future.

The number and value of the outstanding penalties, if accurate, are of considerable concern to me. Specifically, I am concerned about the effectiveness of our current system of enforcing the Commodities Exchange Act, as well as the Department of Justice's general policy toward the collection of penalties owed the U.S. Government.

Therefore, I am writing to request from you a list of the currently outstanding monetary penalties referred by the CFTC to the Department of Justice for collection, including information relating to the date each was referred, the amount of the penalty, and the action that has been taken by the Department of Justice with respect to each penalty.

In addition, I wish to request from you information regarding the aggregate amount of outstanding penalties referred to the Department of Justice for collection by all entities of the Federal Government, as well as a statement of policy reflecting the Department of Justice's policy toward the collection of each penalty. Specifically, does the Department of Justice have a policy—unofficial, informal, or otherwise—of not pursuing penalties whose value do not exceed a certain amount?

I appreciate your attention to this request, and I look forward to receiving your response.

Thank you.

Sincerely,

J. ROBERT KERREY.

Enclosure.

CIVIL MONETARY PENALTIES—SCHEDULE E: COLLECTIONS REFERRED TO THE DEPARTMENT OF JUSTICE AS OF SEPT. 30, 1988

Docket No. and respondent name	Order date	Order amount	Principal outstanding	Date referred Justice
77-22—Muller, John J.	Mar. 22, 1980	$7,000	$7,000	Jan. 1, 1983.
78-19A—Morse, James	Aug. 12, 1982	20,000	20,000	Jan. 1, 1983.
78-198—Porteuse, Peter	Aug. 12, 1982	20,000	20,000	Jan. 1, 1983.
78-19C—Webster, James	Oct. 5, 1978	20,000	20,000	Jan. 1, 1983.
78-48F—Baksheef, Constantine C.	Mar. 20, 1986	70,000	70,000	July 31, 1985.
78-48H—Lincolnwood Commodities, Inc.	Jan. 31, 1984	100,000	100,000	Jan. 25, 1985.
78-54—Rothlin, Robert	Jan. 3, 1984	25,000	25,000	July 31, 1986.
79-26 and 53—Chartered Systems	July 17, 1979	35,000	35,000	Feb. 15, 1985.
79-34—Caceras, Dr. R. Falla	Oct. 26, 1983	200,000	200,000	Jan. 25, 1985.
79-37—Sawyer, Steven	May 22, 1985	100,000	100,000	July 31, 1986.
80-05—Turkish, Norman	Aug. 19, 1982	50,000	50,000	Jan. 1, 1983.
80-07—Allen, Richard	May 23, 1985	100,000	100,000	July 31, 1986.
80-19—Jarboe, James P.	June 16, 1981	5,000	5,000	Jan. 1, 1983.
80-208—Sigler, David	Oct. 28, 1985	5,000	5,000	Sept. 30, 1986.
81-18—Smith, Philip M.	Nov. 14, 1985	25,000	20,000	July 31, 1986.

CIVIL MONETARY PENALTIES—SCHEDULE E: COLLECTIONS REFERRED TO THE DEPARTMENT OF JUSTICE AS OF SEPT. 30, 1988—Continued

Docket No. and respondent name	Order date	Order amount	Principal outstanding	Date referred Justice
81-21—Nesbit, Paul	Aug. 5, 1985	25,000	25,000	July 31, 1986.
82-08—EDP Commodity, Inc.	May 19, 1982	10,000	10,000	Jan. 1, 1983.
82-19—Sweeney, James J.	Oct. 17, 1983	700,000	700,000	Jan. 25, 1985.
82-22A—Murphy, James T.	Mar. 21, 1985	37,500	37,500	Sept. 30, 1986.
82-22B—Sutton, Ross	Mar. 21, 1985	40,500	40,500	July 31, 1986.
82-23A—Benjamin, Maurice	Feb. 23, 1984	4,000	4,000	July 31, 1986.
82-238—Savage, Jack	Feb. 23, 1984	40,000	40,000	July 31, 1986.
82-28—Greenberg, Robert	Dec. 17, 1985	10,000	10,000	July 31, 1986.
82-43—John F. Durkin & Co.	May 2, 1984	1,500	1,500	July 31, 1986.
83-01—Blumeyer-Leckar-Krawisz	June 3, 1983	100,000	100,000	May 30, 1985.
83-19A—Charrier, Michael	Feb. 10, 1984	100,000	100,000	Jan. 25, 1985.
83-19B—Hardwick & Wells & Winth.	Feb. 10, 1984	100,000	100,000	Jan. 25, 1985.
83-19C—Hardwick & Wells Comm.	Feb. 10, 1984	100,000	100,000	Jan. 25, 1985.
83-19D—Thyssen, Elizabeth A.	Feb. 10, 1984	100,000	100,000	Jan. 25, 1985.
83-34—Massaro, James W.	July 7, 1983	100,000	100,000	Jan. 25, 1985.
83-40A—Midwest Commodity Corp.	Sept. 21, 1983	500,000	500,000	Jan. 25, 1985.
83-40B—Socha, Richard S.	Sept. 21, 1983	500,000	500,000	Jan. 25, 1985.
83-41A—Quinn & Co.	Oct. 25, 1983	100,000	100,000	July 31, 1986.
83-41B—Quinn, Terrence	Dec. 31, 1984	100,000	100,000	July 31, 1986.
83-44A—Financial Alternatives	May 4, 1984	100,000	100,000	July 31, 1986.
83-44B—Howe, Rose M.	Oct. 29, 1985	5,000	5,000	July 31, 1986.
83-44L—Howe, William	Oct. 29, 1985	100,000	100,000	Dec. 22, 1986.
84-04—Bamaodah, Ahmed	Apr. 18, 1986	30,000	30,000	Sept. 30, 1986.
84-27—Puncerelli, Kenneth J.	Jan. 8, 1986	45,500	45,000	July 31, 1986.
84-39—Sarmad, Syed	May 6, 1985	10,000	10,000	July 31, 1986.
85-09—Palermo Financial Syndicate	Apr. 24, 1985	50,000	50,000	July 31, 1986.
85-13—Miller, Stephen A.	July 3, 1985	40,000	40,000	July 31, 1986.
Total collections outstanding			3,826,000	
Count			42	

CFTC—CIVIL MONETARY PENALTIES

Fiscal year	Penalties imposed	Penalties collected [1]
1976–1977	$357,000	$21,000
1978	82,000	118,000
1979	307,000	217,000
1980	212,500	256,000
1981	1,543,084	1,108,583
1982	622,000	519,000
1983	2,960,000	1,181,000
1984	3,500,800	908,300
1985	2,788,600	973,200
1986	8,084,900	2,677,000
1987	1,947,500	3,398,585
1988	2,337,500	706,075
Total	24,742,884	12,083,743

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[1] The discrepancy between the amount of civil penalties imposed and the amount collected in any given year is accounted for by the following factors: (1) penalties imposed in 1 year may not become due and payable until the next year; (2) a penalty may be stayed by appeal; (3) some penalties call for installment payments which may span 2 or more years; (4) delinquencies assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (5) penalties may have been referred to the Attorney General for collection; and (6) collection process still being pursued internally.

Prepared Statement of Hon. Rudy Boschwitz, a U.S. Senator From Minnesota

HEARING ON TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

Mr. Chairman, since last January when we first learned of the FBI investigation into trading practices at the Chicago Board of Trade, and the Chicago Mercantile Exchange, lots of heat, and not a lot of light has been shed on the issue.

It's pretty tempting for politicians to grab the limelight and bash the exchanges and traders for real, or imagined excesses. What we sometimes forget is that people's lives and livelihoods are at stake, so it's important that actions that we take on this committee represent a constructive solution to the problem.

Much of the discussion in the earlier hearings has been centered around maintaining the strongest possible incentive for self-policing of the exchanges. My friends and acquaintances who are in this business describe an overriding incentive. That incentive is the need to maintain public trust and confidence. Without public confidence in the integrity of the system, it will cease to function.

We're going to hear from four individuals representing four very large commodity exchanges. I've personally known Leo Melamed for many years, and have the utmost confidence and respect for his ability and character. The Chicago Mercantile Exchange has come up with some bold proposals designed to make the system more accountable, and to bolster public confidence in the commodity exchanges. Mr. Melamed and his fellow committee members worked hard, and should be commended for their efforts.

A report on the recommendations of the CME Special Committee to Review Trading Practices contains some additional views by former Senator Thomas Eagleton. He makes a couple of points that I especially agree with when he says:

"The trading exchanges have the initial duty to keep their own houses clean. That's self-regulation. But when it comes to the policing of millions of public transactions involving billions of dollars, then the government must effectively play its responsible oversight role. Government—in this instance, the CFTC—must mandate standards sufficient to guarantee investor confidence and then vigilantly backstop the exchanges' effort to police these public marketplaces."

Recommendations contained in the report are bold, and in my view, responsible. We should carefully consider how their implementation can improve upon the current situation, and provide a constructive solution. I wish to take this opportunity to again thank Mr. Melamed and these other gentlemen for their efforts on this important issue.

STATEMENT OF LEO MELAMED, CHAIRMAN, EXECUTIVE COMMITTEE, AND SPECIAL COUNSEL TO THE BOARD OF GOVERNORS, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL

Mr. MELAMED. Mr. Chairman, Mr. Baucus, members of the Committee on Agriculture, Nutrition, and Forestry, I thank you for this opportunity to respond to your inquiry with respect to the trading practices, and the resulting fallout from the Federal probe that was conducted in Chicago beginning earlier this year.

Mr. Chairman, the basic philosophy of the Chicago Mercantile Exchange is that the right to self-regulate is essential to the success of our industry. The reason that self-regulation is the key to our philosophy is quite simple; we recognize that the right to self-regulate is the freedom to innovate.

You cannot have one without the other. They work hand-in-hand. And it is the freedom to innovate that has been the foundation of the Chicago Mercantile Exchange's phenomenal growth.

In responding to your inquiry, I would like to submit for the record our written response, as well as the report from the Chicago Mercantile Exchange Special Committee to Review Trading Practices, and merely touch on the highlights of those recommendations.

The CHAIRMAN. Thank you. The whole statement will be made part of the record; and proceed however you would like.

Mr. MELAMED. As I said, the basic philosophy to self-regulate gives us the inherent right and freedom to innovate; and it is that freedom that has brought the Chicago Mercantile Exchange from a relatively lowly position in markets just a few years back, to the forefront of markets worldwide.

We became a center of financial and agricultural activity in just, perhaps a decade and one-half. Today, as you know, we offer services and risk management tools in markets as diverse as any exchange in the world can possibly offer, from cattle to currency, from hogs to Eurodollars, and virtually everything in between, including stock index markets.

Our volumes in these last 15 years went from approximately 5 million contracts to approximately 78 million contracts last year. It is an increase on average, of better than 20 percent per annum.

It was self-regulation, and the freedom to innovate, that led to these successes. Along with the enormous volume, came world-wide recognition and prestige. This enabled us, recently, to launch an innovative, electronic system that will offer after-hour transaction capability; eventually it will provide the world with a 24-hour capability to continue to do futures business around the clock and around the world. It will help maintain the financial services market for the United States, and hold back the tide of foreign competitors.

It is again that freedom to innovate that has provided us the privilege and right to create Globex, our innovative system. We plan to launch Globex by October of this year. But implicit in the freedom to innovate is the fact that we must maintain the responsibility to self-regulate. If we do not act in a responsible fashion, as you indicated in your opening remarks, Mr. Chairman, then self-regulation itself might be removed or, in some fashion, changed.

If we lose the right to self-regulate, we lose the right to innovate. And therefore, throughout our enormous growth and success, the Chicago Mercantile Exchange has been ever conscious of its need to be responsible with respect to self-regulation. And we have consistently increased the surveillance, compliance, and the standard of floor practices at our exchange.

Indeed, several years back, we went through a dramatic change in the trading practice and surveillance area such that we increased the fine schedule from something like $50,000 per offense to $250,000 per offense.

We increased the surveillance and compliance staff by over 100 percent. And 2 years ago, in a dramatic, historical departure with the traditional way of doing business in futures markets, we experimented with a change whereby 95 percent of the business in stock index futures became non-dual-traded. That occurred in 1987.

That is a brief history of the Chicago Mercantile Exchange's commitment to self-regulation. It is sacred, and it is an obligation. And when, earlier this year, we discovered the Federal investigation of futures markets in Chicago, we decided to use that as an opportunity to examine our trade practices and rules in a very comprehensive and open fashion, so that the CME could meet the challenges of the coming decade in terms of trade practices.

Our Board of Governors created a Special Committee to Review Trading Practices composed of figures from both industry and the public. The Special Committee was charged to examine the trade practices of the Chicago Mercantile Exchange and its surveillance and compliance procedures in the most comprehensive fashion possible.

The result of that comprehensive undertaking is before you today. The report of the Special Committee includes, among many suggestions, a recommendation to prohibit dual trading in all mature liquid contracts of the exchange. It recommends some basic changes, such as including public, non-member appointees on disciplinary committees. It suggests minimum sentence guidelines with respect to violations that involve public customers. It suggests that compliance staff be allowed an appeal from adverse decisions of the probable cause committee. It suggests a host of upgrades with respect to computerized trade reconstruction (CTR). It suggests a ban on members of a broker group from trading with each other when one is trading his personal account and the other is trading for a customer.

The CHAIRMAN. Members of a——

Mr. MELAMED. And it includes recommendations for education and ethics classes for old members and new members alike. I will not go through each of the points, since the report is comprehensive. The process took over 3 months and included many witnesses from academia, attorneys, FCM's, traders, users—every segment of our exchange. The report was as comprehensive as possible, and we have been advised by observers that these recommendations have been applauded in every segment of our industry.

Those recommendations are now undergoing review within the exchange. We expect refinement. We expect some adjustment. But we expect that ultimately, the essence of those recommendations will go to referendum to our membership. We expect that process to be completed within 90 days.

Mr. Chairman, that is our record; that is our mission. And we submit that the Chicago Mercantile Exchange understands and lives up to the requirements and responsibility inherent in maintaining a self-regulatory posture.

I thank you.

[The prepared statement of Mr. Melamed and the report of the Chicago Mercantile Exchange Special Committee to Review Trading Practices to the Board of Governors appears at the conclusion of the hearing.]

EDITORS NOTE.—The appendices to the above-mentioned report is retained in the committee file.

The **CHAIRMAN**. Thank you very much, Mr. Melamed. I appreciate the time you and your associates have spent with the committee and staff members of the committee, in keeping us apprised of what you are doing.

Mr. Mahlmann, you are here to represent the Chicago Board of Trade. And sir, we look forward to hearing from you.

STATEMENT OF KARSTEN MAHLMANN, CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, IL

Mr. **MAHLMANN**. Thank you, Mr. Chairman, Senators.

My name is Karsten Mahlmann. I am Chairman of the Chicago Board of Trade. Also with me today, representing the exchange, is Thomas Donovan, president and Chief Executive Officer of the exchange.

Mr. Chairman, the Chicago Board of Trade shares a common objective with this committee, the U.S. Attorney in Chicago, the Commodity Futures Trading Commission, and our competitors at this table—we all want the United States futures markets to be the fairest and most reputable in the world. To accomplish this objective, the Board of Trade has been committed for more than 140 years to providing market users with the only two things we really have to offer—our integrity and our markets' liquidity.

We recognize, Mr. Chairman, that in recent months, some have questioned our integrity and expressed doubt about our ability to police our markets. To those people, I say, you do not know the Chicago Board of Trade. Our membership is committed to effective surveillance of our trading floor and tough member discipline where warranted. If we find that one of our members has cheated a customer, we deal with that member severely. Why? Because our existence depends on our integrity.

For the same reason, if any of our members are prosecuted and found guilty of customer abuses, we would expect and support penalties commensurate with the crime. To date, of course, this is all speculation—no one has been indicted, much less convicted. But we wanted you, Mr. Chairman, and this committee to know, today, that we take this matter very seriously.

Mr. Chairman, the questions you have asked us to address in these hearings all go to the issue of market integrity: how effective are our current surveillance and disciplinary programs and what have we done to improve them? The short answer is that our existing programs are very effective. United States Attorney Anton Valukas shares our view. As Mr. Valukas stated publicly as recently as October 21, 1988, at the Kent Law Institute Workshop on Enforcement and Criminal Matters, and I quote:

> In my estimation based on my own expertise in the area, the best experts in the world concerning trading practices are the members of the Board of Trade. I have a great deal of confidence in the staff of the Board of Trade. They are able to ask the difficult questions; they have the resources to identify trading practices in which fraud has occurred. And frequently, in my experience, when they are holding their hearing, they are able to get to the tough questions quickly.

Mr. Chairman, like you, like U.S Attorney Valukas, we have a great deal of confidence in the Board of Trade's self-policing capabilities. For the record, I would like to submit a written response to your specific questions describing our surveillance and disciplinary programs. In brief, our current surveillance program emphasizes the innovative use of computer technology to detect trading improprieties. The cornerstone of this program is our computerized trade reconstruction system—which we call CTR. The CTR system has been a success. Already we can rely on this computerized filter to sift through hundreds of thousands of trades and identify any questionable transactions. For example, the CTR filter caught the trading irregularities of one of the alleged FBI agents on our trading floor.

Once we became aware of potential trading abuses, as U.S. Attorney Valukas noted, our disciplinary proceedings provide an expeditious mechanism to uncover the relevant evidence and to take disciplinary action if violations are found. When we take such action, our decision is reviewed by the Commodity Futures Trading Commission. If that agency believes we have been too lenient, the Commission may strengthen the penalties we impose. If the Commission concludes we have been too harsh, and this has happened, the agency can reduce or vacate our disciplinary action.

This process combines the expertise of our members with the checks and balances of CFTC review. The "private club" atmosphere that some believe pervades the exchange disciplinary process is simply a myth.

Despite our confidence in the existing surveillance and disciplinary programs, we know they can be improved. We recognize that media rumors about the FBI investigation may have diminished public confidence in our markets. Because we could not risk losing this confidence, in recent months the Board of Trade has accelerated efforts to perfect our surveillance capabilities and disciplinary procedures.

Mr. Chairman, to date our efforts have produced a comprehensive package which includes 19 specific measures that have already been adopted by our Board of Directors. Many of the steps are already in effect. Others will be implemented as soon as possible. These 19 measures are spelled out both in the attachment to my prepared statement and our written submission. As a package, these actions show the depth of our commitment to better our existing systems and to use state-of-the-art technology to accomplish this goal.

This package includes the expenditure of an additional $1 million to supplement our CTR capabilities with new technology. In addition, since April 1 the Board of Trade has audited through its enhanced CTR programs 100 percent of all transactions on our exchange. This would be equivalent of the Internal Revenue Service auditing every single taxpayer. Other measures—including our new Electronic Order Routing System (EOS)—make the trade timing data analyzed in our CTR filter even more accurate, particularly so for customer transactions.

Thus far, of the two things we have to offer, I have talked only about integrity and not liquidity, at least directly. But integrity and liquidity have a symbiotic relationship. So long as market users have confidence in our markets' integrity, they will use our markets. The resulting liquidity enables us to provide the fairest and most reliable prices in the world.

The sustained and dramatic growth of our markets demonstrates that our market users continue to have confidence in our integrity. In fact, in recent years, we have received only a handful of complaints from market users.

The FBI investigation has rekindled public debate, yet again, on another aspect of this relationship between integrity and liquidity—dual trading. Some believe that dual trading should be severely restricted or even banned. We do not share that view.

Dual trading is the practice of allowing floor brokers to handle customer orders and trade for their own accounts. These broker traders are, however, prohibited from trading ahead of or against their customers. The combination of principal and agent functions is common in a global financial world that includes broker-dealers, specialists, banks and many others. In our markets, we monitor these practices daily. Given the deluge of adverse publicity, we did consider imposing additional restrictions on dual trading. Two things stopped us—our market users and the facts.

As our written statement describes, in response to the notoriety this issue received, our market users contacted us by letter and phone to endorse overwhelmingly retaining the existing trading practices. These market users—big and small alike—told us that our markets needed the liquidity provided by broker traders in order to provide the low-cost price efficiency and hedging opportunities users of our markets have come to expect.

Due to this expression of concern, and at the request of the CFTC, we began to analyze the extent of broker trading in certain trading pits on our floor. This preliminary study indicated that our market users were right—broker trading contributes more than even we believed to our markets' liquidity. While this evidence is just preliminary, it told us that the best available minds must study this issue. Therefore, we commissioned a comprehensive study of dual trading by Dr. Sanford J. Grossman, the John F. Weinberg professor of economics at Princeton University. Dr. Grossman's impeccable credentials include studies he has undertaken for the New York Stock Exchange as well as the Board of Trade.

This we believe is the right "management by objective" approach. The objective is to foster honest, efficient, liquid markets. To accomplish that objective, each exchange should be directed to take whatever steps are necessary to improve their unique surveillance mechanisms. Market integrity will be assured by developing systems to detect any abusive trading practice in the way that is most appropriate for each market.

Further, the CFTC has stated that it will study the impact of broker trading. Thus, the agency Congress empowered to regulate dual trading already is embarked on its own examination of this issue.

This committee also has initiated action by the General Accounting Office to assess dual trading and other relevant issues. The results of these studies will provide a framework for reasoned decision-making by all parties in this area.

As our experience over the past few months indicates, precipitous action on this issue could result in adverse consequences for those who look to our markets for the liquidity necessary to hedge their commodity price risk. If we do not provide that liquidity, our foreign competitors are ready to take our markets. Again, this is something on which we can all agree. No one wants that to happen.

For its part, the Board of Trade will take whatever steps are necessary and appropriate to ensure that the National asset of honest and liquid futures markets is never lost. That is our commitment to our members and that is our commitment to you, Mr. Chairman, and this committee.

Thank you very much.

[The prepared material of Mr. Mahlmann appears at the conclusion of the hearing.]

The **CHAIRMAN**. Thank you very much, Mr. Mahlmann.

Mr. **MAHLMANN**. I also submit the full statement for the record.

The **CHAIRMAN**. Thank you. And it will be part of the record.

Mr. Guttman, go ahead, sir.

STATEMENT OF Z. LOU GUTTMAN, CHAIRMAN OF THE BOARD OF DIRECTORS, NEW YORK MERCANTILE EXCHANGE, NEW YORK, NY

Mr. **GUTTMAN**. Good morning, Mr. Chairman and members of the committee. I am Lou Guttman, Chairman of the Board of Directors of the New York Mercantile Exchange (NYMEX). We appreciate this opportunity to appear before the committee and to present its views on the important subject matter of these hearings. Before taking your questions, I would like briefly to describe the background of the exchange, provide an overview of our surveillance and compliance systems and summarize some of the important recommendations made by our recent Regulatory Review Task Force.

NYMEX is the Nation's third largest futures and options market, providing trading facilities for crude oil, heating oil, gasoline, propane, platinum, and palladium contracts. Although NYMEX began trading oil futures contracts, which are the heart of our business just 10 years ago, its total volume reached nearly 35 million contracts last year. Today, NYMEX is recognized as the prize discovery and risk management forum for a major share of the petroleum and platinum group metals traded both here in the United States and throughout the world.

The users of NYMEX's markets are a broad spectrum of energy and precious metals industry participants, representing every sector of the marketplace from producers through end-users, both in the United States and abroad. Without a high degree of confidence by this constituency in the operation and integrity of the exchange and its contract markets, NYMEX never would have gained its prominence as a world market.

NYMEX's success emanates, in part, from its attention to, and reevaluation of, its own compliance systems. Not only must the exchange satisfy the Congress and the CFTC, but to maintain its business, the public must have complete confidence that trades on the exchange are executed fairly and competitively, and that prices reflect market forces. For these reasons, effective trade practice surveillance and compliance programs are essential.

The foundation of every trade practice surveillance and compliance program is the audit trail—which provides the ability to reconstruct market activities. The NYMEX audit trail is generated from the pit card submission system implemented by NYMEX over 10 years ago. The pit card system requires transaction-by-transaction submission of hard trade data—buyer, seller, commodity, quantity and price—trading information to exchange officials who time-stamp the pit card immediately upon receipt. It is the only audit trail mechanism of its kind, providing the most accurate, complete and tamper-resistant procedure for audit trail creation.

The pit card submission procedure enables NYMEX to continuously input all trades into its computer system throughout the day, and display these trades on computer screens located on the exchange floor and in the exchange's Compliance Department for online review. From a self-regulatory standpoint, we believe that same-day peer review and Compliance Department scrutiny provide, not only an effective audit trail, but also a significant deterrent to certain trade practice abuses.

NYMEX also uses information from the pit cards to construct a Streetbook—NYMEX's trade register. The Streetbook provides a chronological trade sequence based upon minute-by-minute exchange time-stamping of pit cards. With advancements in computer technology, the Streetbook is available on interactive computers for selective study and review by the Compliance Department. In addition, computerized surveillance programs help the Compliance Department staff generate investigations.

NYMEX has also made a major human resource commitment to its compliance program. The exchange is presently budgeted for 33 full-time compliance professionals, up nearly 50 percent since 1986. This represents approximately 20 percent of the total exchange professional staff. The exchange's Compliance Department is headed by a former CFTC enforcement attorney who reports directly to the NYMEX president, and is also accountable to a Compliance Review Committee which regularly oversees Compliance Department operational procedures.

NYMEX has been equally diligent in developing educational programs and guidelines to govern the ethical and legal conduct of its members and its staff. In 1988, the Exchange adopted Ethics Guidelines for members, and a Conflicts of Interest statement for employees. Both were designed to alert members and staff to potential conflicts of interest that could weaken the effectiveness of the exchange's compliance program and disciplinary structure. Violation of the Ethics Guidelines is a major exchange rule violation. In addition, NYMEX conducts a broker training program which introduces all new members to these ethical issues, as well as to the relevant legal and regulatory principles which govern their conduct on the exchange.

While we believe these measures to be substantial and effective, investigations both in Chicago and New York remind us that we can never be complacent. Last February, the NYMEX Board established a Regulatory Review Task Force comprised of nine directors, including two of its public directors. The Task Force's thorough review of the NYMEX trading rules and practices has produced a comprehensive set of recommendations to the Board. A copy of this report was sent to all members of this committee just last week. Among the Task Force's major recommendations are:

One, that technological enhancements be studied to improve NYMEX's performance under the one-minute time-stamping standard.

Two, that additional resources be committed to the NYMEX Compliance Department, for increased staffing levels and to fund the development of additional computer assisted surveillance tools.

Three, that all formal and informal broker affiliations be required to register with the exchange to enable the Compliance Department to better monitor their trading activity.

Four, that there be an absolute ban on cross-trading by a member for his own account against the account of his customer. Trades for the account of one customer against another, executed as cross-trades, would be reported as such via the exchange's price reporting system for immediate review by exchange's staff, membership and the public.

Five, that the composition and operation of the exchange's disciplinary committees be expanded to include non-exchange members on disciplinary committees and to increase the level of education, experience and understanding of policy on disciplinary matters by all committee members. Members who have been found to have committed certain major exchange rule violations would be prohibited from serving on exchange disciplinary committees for appropriate periods.

Six, that penalties for violations be increased and that the names of persons found to have engaged in significant violations be widely disseminated.

Seven, that at least until further studies are completed, dual trading be permitted to continue at NYMEX. Throughout its more than 100 year history, NYMEX has granted dual trading privileges to its floor members. Dual trading enhances market liquidity, narrows bid/ask spreads and brings additional market participants to serve as market-makers and provide "shock-absorbers" during periods of extreme volatility. Additionally, more traders translates to greater price competition benefiting public customers. The exchange rules, surveillance systems and compliance efforts have always been designed to provide supervision of this practice so that the privilege is not abused. The Task Force's recommendations would enhance this level of attention while preserving the economic efficiencies fostered by the exchange's traditional practices.

The recommendations of the Task Force are the top priority of the entire Board and senior management of NYMEX. I intend to see that these recommendations are adopted and that NYMEX's continued attention to its responsibilities as a self-regulatory organization shall not diminish.

Significant changes and growth have occurred over the past 5 years that magnify the scope and importance of NYMEX's markets. The integrity of our markets and public confidence in NYMEX's ability of NYMEX to self-regulate is essential to our continued effectiveness and success.

We believe that the goals of market efficiency, contract performance and effective deterrence against abuse can best be met through the existing self-regulatory structure. Through this approach, NYMEX has increased market participation within the petroleum and precious metals industries, and lowered transaction and information dissemination costs. We strongly urge that the Commodity Exchange Act continue to permit NYMEX to successfully meet the pricing, hedging and performance guarantees demanded by global commerce.

At the same time, we continue to accept the challenge of reassuring the public, the Congress, the CFTC and our members that NYMEX will take the appropriate regulatory actions and commit the human and financial resources to provide a marketplace whose operation and integrity are unsurpassed.

Mr. Chairman, the work of this committee, and Congress, is of great importance in maintaining the public confidence in the integrity of the markets. As the reauthorization process unfolds, we, of course, will do everything we can to cooperate with and assist this committee.

Thank you, Mr. Chairman and members of the committee. I will be pleased to answer any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Guttman. I appreciate your statement.

Mr. Fink, you are the first vice-chairman of the Commodity Exchange, Inc. Go ahead, sir. I know you are delighted to be here, as everybody is.

STATEMENT OF ROBERT E. FINK, FIRST VICE-CHAIRMAN, COMMODITY EXCHANGE, INC., NEW YORK, NY

Mr. FINK. I am, sir. Thank you, Mr. Chairman. And thank you, members of the committee.

I am Bob Fink, first vice-chairman of the Board of Commodity Exchange, Inc. (COMEX). I also serve as chairman of the COMEX Business Conduct Committee—the Business Conduct Committee reviews investigations of potential rule violations by exchange members and determines whether to institute disciplinary proceedings against suspected wrongdoers. COMEX is the world's most active metals futures market, and the fourth most active of all futures markets in the United States. Our exchange provides an arena for the trading of futures contracts on gold, silver, copper, and aluminum, and options on gold, silver, and copper. The users of our markets include speculators, commercial and industrial hedgers, and major financial institutions—both in the United States and abroad.

I am pleased to be here this morning to share COMEX's views on the important issues raised in this series of hearings. As Chairman Leahy pointed out in his letter of invitation to us, all of our exchanges have a major stake in this debate. On behalf of our exchange and its many users, I thank you for the opportunity you are giving us to participate in these proceedings.

Mr. Chairman, let me begin by saying something that I hope will come as no surprise to you: The overwhelming number of participants in our markets are both ethical and law-abiding. However, there have been, are now, and will continue to be a small number of violators in all of our exchange communities who seek to take advantage of not only nonmember customers, but fellow members as well. It is clearly in the interest of our exchange to ferret out violators by having in place a regulatory framework that detects misconduct, publicizes it, and imposes tough sanctions against it.

In the existing regulatory framework, the front line of defense against abusive trading practices is the exchange itself. But can an exchange properly discipline itself and its members? The experience of COMEX tells us that it can. *It can* if the exchange places rule compliance high on its list of operating priorities. *It* can if it provides its Compliance Department with effective tools of detection. *It can* if it endows its compliance force with independence of action that places it beyond the influence of any member or special interests. And *it can* if its disciplinary committees impose sanctions that make the clear statement that no matter how big or small the violation—or the violator—misconduct will not be tolerated.

The evidence at COMEX speaks to the point:

For its size and volume of trading, COMEX devotes significant money and staff to its compliance effort.

For its size, COMEX generates more and greater sanctions than any other exchange—attached to my testimony is a tabulation of COMEX's disciplinary sanctions issued in 1984–88 for violations arising from trading activity. As a member of the COMEX floor community, I can attest to the impact these sanctions have had on traders' expectations of being caught and punished for their violative acts.

COMEX's commitment to dealing with misconduct fostered trading rules which have been in place at our exchange for some time, many of which may only now be gaining wider industry acceptance. Examples of such longstanding rules and practices are those one, prohibiting members from taking the opposite side of a customer order; two, those prohibiting any member of a broker association from taking the opposite side of another associate's customer order; three, those requiring that both sides of every trade be manually recorded to the nearest minute; four, those requiring that trading cards be submitted every half-hour; and five, those providing that two-thirds of the members of our two major disciplinary committees are representatives from futures commission merchants and trade houses—the "outside" users of our markets. Every exchange, Mr. Chairman, has at least one of these rules. But to the best of our knowledge, only COMEX has all of them.

This list of COMEX rules and practices raises the question, is the regulatory framework effective when it permits seemingly significant differences in rules and practices to exist between its constituent institutions? We believe the record is not clear on this point. Such considerations as market conditions, operational constraints, and tradition give rise to differences in the way any two exchanges conduct their activities. For this reason, the blanket application of uniform rules of conduct is not feasible. However, comparative statistics dealing with the size of exchange compliance staffs, expenditures for compliance, and monetary sanctions against members show surprising disparities among the exchanges. Regulatory reviews of the exchanges' compliance efforts also disclose differing degrees of complexity and breadth of the investigations they conduct and of the violative acts uncovered and sanctioned. It is difficult to understand how a single regulatory mechanism can expect to stride smoothly toward the goal of fair and honest trading when its tools of measurements tolerate so many standards of performance among its moving parts.

The COMEX record of instituting and enforcing meaningful trading rules is one that we are proud of. However, we cannot take full credit for our achievement. While we would like to say that our progress toward the goal of an honest trading environment is all self-generated, there is no denying that, at critical points along the way, we have been poked by the sharp prod of the Commodity Futures Trading Commission. For example, in the early 1980's, the Commission discovered some sloppiness in our procedures and put pressure on us to improve. More recently, the CFTC took the approach that we should automate our investigative procedures. With computer-generated reports that identify suspicious trading patterns, our investigative procedures have become more effective in spotting cases of abuse. Anyone at our exchange who is inclined to cheat knows now, more than ever before, that he must slip through an increasingly sophisticated and sensitive network of detection. We owe much of this improvement in our performance to the rule enforcement reviews of the CFTC.

Spurred by the ongoing regulatory pressure and the heightened recent pressure imposed by the investigations into industry trading practices, further improvements are in progress. For example:

In August 1988, the CFTC found that the COMEX audit trail system was effective and that 87 percent of all our trades were accurately recorded to within one minute of the time of execution. However, as the Commission pointed out, improvement is needed. As part of a planned program to substantially upgrade performance, we are awaiting CFTC approval for the authority to impose summary fines for violations of the one minute recordation requirement. In addition, our operations committee has already undertaken a study of hand-held devices and other automated means of recording trade execution on a live, real-time basis.

In the area of trading card control, our trade entry system requires the collection of trading cards and order tickets every half hour and transactions are entered into the system by clearing members at least once every half hour. To the best of our knowledge, no other U.S. futures exchange captures complete trading data as promptly or as frequently as COMEX does. Nonetheless, we are reviewing the feasibility of implementing a still more frequent collection schedule. In addition, we are now studying mandatory sequencing of trading cards and a prohibition against line skipping.

In the area of surveillance, we are performing an internal study that will consider the benefits of extending our existing floor surveillance by posting observers in the trading rings and by using video cameras. Moreover, the exchange is constantly enhancing its ability to produce computerized reports that detect violative trading behaviors.

Finally, COMEX has established a special advisory panel, appointed by the Board of Governors of the exchange, for the purpose of reviewing current exchange and industry practices. This group already has addressed the audit trail and dual trading issues. Its views, which were endorsed by the exchange, are contained in our April 28, 1989 letter to the CFTC's Division of Trading and Markets. A copy of that letter is appended to our written statement. The work of this Special Advisory Panel is expected to spawn focused discussion and action on the many issues that have surfaced in the last 5 months.

The current investigations into futures trading practices, the issuances of subpoenas, the accusations of fraud are all matters of grave concern. When resolved, they may show that parts of the industry's system are not working well. But our ability to uncover these weaknesses is evidence that the system as a whole is working well. Through some combination of industry conscience and Federal pressure, the entire system is rising up in reform. The system's ability to change, adapt, and move on is more important than even the most serious failings of one of its parts.

It is imperative that every participant in the futures industry treat this process of adaptation with respect. Proposals for change—such as those affecting dual trading—should be based on hard facts, clear reasoning, and honest motives. Above all, they should not be based on the cynical logic that this or that concession is what will be necessary to keep the regulators off our backs or make for a smoother CFTC reauthorization. Instead, the focus of consideration of market reforms should be on each exchange's capability to detect potential trading abuses and commitment to deal with abuses once disclosed.

The panelists sitting here today are all eyewitnesses to and, in the case of my colleagues, authors of one of the most exciting stories in American business history. The U.S. futures market has filled a void in the world economy in ways that could not have been foreseen by even its most visionary leaders. It has developed into the most efficient market machine in existence, providing users around the world with the cheapest available means of moving huge quantities of vital commodities and financial products. And it continues to do this, despite the existence of abusive practices.

As abhorrent as these practices are to all of us, the continued rapid growth in futures trading is telling us that their toll is still relatively small compared to the far greater benefits our markets provide. Let us not lose sight of this as we press forward for reform.

Every stakeholder in the industry must proceed with commitment to wipe out corrupt practices. But let our approach be cooperative, thoughtful, and determined, not splintered and rash. In this way, we may leave unharmed those aspects of the system that have served us well.

Thank you, Mr. Chairman.

[The prepared material of Mr. Fink appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you very much, Mr. Fink.

Senator CONRAD. Mr. Chairman, if I just might. I have another obligation. But I would like to receive consent for submission of my opening statement and a series of questions for the witnesses before I leave.

The CHAIRMAN. Without objection, it will be so ordered.

[See the contents for the opening statement and questions of Senator Conrad.]

The CHAIRMAN. I might note, with all the other hearings going on, that there are a number of Senators from both parties who are required to be elsewhere. I would make that as the rule on this, if they wish, any Senator will have leave to submit an opening statement and questions.

Thank you.

Senator CONRAD. I appreciate that, Mr. Chairman.

The CHAIRMAN. I was thinking, Mr. Fink, of what you, Mr. Guttman, and others have said. There has been a great deal said about self-regulation in the futures industry. I mean, it has been a hallmark of this industry and its growth. But the hearing today and similar hearings to be held here on Capitol Hill will determine to what extent, if at all, such self-regulation continues, or whether it will be a case where Congress will step in with specific guidelines.

I would like to start looking at a number of issues that have come before us, both from the testimony and by individual members during the past few weeks. I think that the testimony of all four of you is very significant and very important to this hearing.

Let us take a look at one thing: The proposal to improve regulation of trading floors by limiting dual trading. For those who are not aware, dual trading is where a floor broker trades his own account while, at the same time, executing orders for customers. Many have argued that this practice has an inherent conflict of interest. We have asked the GAO, in its review of futures trading practices, to try and document the extent to which customer abuses could result from it.

Now, from the public statements that have come from each of the exchanges, I gather that each of you agrees that if dual trading continues, it has to be side-by-side with an audit trail system that makes it possible for you, the exchange, to police it against abuses such as a brokers' trading his own account ahead of his customer's order. Is that correct, Mr. Mahlmann?

Mr. MAHLMANN. There is no question about it, the exchange is absolutely committed to detect 100 percent of any trade abuse, whether that be dual trading or any other abuse. And the surveillance system is in place, and it is monitored at the Board of Trade on a daily basis on 100 percent of its trades since last month. When a broker trades ahead of his customer it is a violation of our exchange rule. We are monitoring for that potential violation. If it does occur, we punish it severely.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Mr. Chairman, you are 1,000 percent correct. If dual trading is going to be allowed to continue, we have to assure you that we have the tools in place to monitor any potential trading abuse.

In fact, in the third quarter of 1988, the NYMEX implemented a special computer software program which we refer to as 1C–4C, specifically to detect any potential running ahead of customer orders. It brackets when a broker trades at a better price than his customer, within a specified time before or after his customer, so that the Compliance Department can further investigate the trades.

Since the last quarter of 1988, the Compliance Department has commenced 16 investigations using this particular computer software program. We feel that NYMEX, and as I hope the rest of the exchanges, are addressing computer software needs to detect just those abuses and, of course, certain others.

The CHAIRMAN. Mr. Fink.

Mr. FINK. Mr. Chairman, COMEX believes that the focus of attention on reform, these kinds of issues, and the protection of customer orders should be focused toward the issues of detecting abuse, proper audit trail, good surveillance and a sanction mechanism that will severely punish those people who are proved to be violators of our rules.

We have not had any demonstration, yet, that dual trading is a cause of or even linked substantially to those abuses. Obviously, any persuasive evidence that that is the case will cause us to change our opinion of the practice. At the moment, right now, we are concentrating—as we have always been concentrating—on the tools of detection and the appropriate punishment for crimes.

The CHAIRMAN. But proceeding from the issue of whether dual trading will be allowed to continue or not, if it is allowed to continue, you do agree that it should be side-by-side with an audit trail system?

Mr. FINK. Yes, Senator. It is essential that those two be linked.

The CHAIRMAN. I assumed that from your earlier testimony.

Mr. Melamed.

Mr. MELAMED. The answer to your question is in the affirmative, of course. But in addition, the Chicago Mercantile Exchange, as evidenced by the report of its Special Committee, has concluded that this inherent conflict of interest is a delicate balance between the liquidity that dual trading provides, and the danger to the public that it might spawn.

And in making that delicate balance work, the Chicago Mercantile Exchange Special Committee concluded that we can risk that balance so long as the decisionmaking power with respect to dual trading is left at the exchange, where the experience is inherent in the membership and in the Board of Governors to decide which contracts are mature and which can survive a dual trading prohibition.

When contracts have reached a maturity and liquidity level that the Board and the exchange decide is sufficient to risk the removal of dual trading, then, the exchange will prohibit dual trading in those contracts. At the present time, the recommendation of the Special Committee would restrict dual trading in approximately 80 percent of the business flow to our markets. Of course, those recommendations are now undergoing a review by our own committee structure to determine the practicality of that.

The CHAIRMAN. In March, I sent out a number of proposals, just for comment, to see how people felt about some of these issues. One of them was that dual trading be barred in any liquid trading pit where the exchange could not demonstrate that its audit trail system, in fact, worked within a 1-minute accuracy rate of, say, about 90 percent.

Otherwise, I felt, as I noted when I sent out those ideas for comment, that we could not assure the public that dual trading abuses were being policed. Now, according to the CFTC, each of your exchanges currently has an audit trail accuracy rate of 85 percent or better.

Do any of you doubt that, given your commitment to integrity and your access to technology, that you can refine your audit trails to maintain an accuracy rate of 90 percent or better? Is this doable, Mr. Mahlmann?

Mr. MAHLMANN. Mr. Chairman, number one, the CFTC rated the Board of Trade's accuracy rate at 88 percent; that accurate time as assigned in the Board of Trade's case is down to the second. We keep our time and sales journal down to the second; so we will have an 88 percent accuracy down to the second.

In addition, we are in the process of allocating an additional $1 million to improve, number one, the raw data of the CTR audit trail and the subsequent massaging of our numbers in our CTS-plus surveillance program. In order to do that, we have bought a relational data base which now lets us monitor every trade in multiple-trade regressions on 100 percent of every trade that occurs on our exchange.

The Board of Trade will achieve, and will not be satisfied, with the 90 percent accuracy. We want 98 percent. We want 99 percent.

The CHAIRMAN. So, as a minimum standard, there is no reason why investors cannot expect at least 90 percent; is that a fair statement?

Mr. MAHLMANN. They can expect it. They will get it, because we are committed to retain the benefits of dual trading while eliminating any potential abuse.

The CHAIRMAN. Mr. Guttman, do you agree with that? We can ask for at least that as a minimal standard?

Mr. GUTTMAN. The minimum standard is quite achievable, Mr. Chairman. I would like to point out that, in our exchange, the reason why we are just below 90 percent is all our transactions are reported on a transaction-by-transaction basis to an exchange employee in the form of a pit card. Every transaction that is transacted on our exchange, a broker must take an extra measure, not only just to record it on his trading pad, but fill out an official form on a transaction-by-transaction basis, submit it to an exchange employee who clocks this card to the minute of the transaction.

Now, this extra step is what obviously has to be improved upon to move from the 86-some-odd percent, up to 90. We sincerely feel that we can achieve the 90 percent because we have now developed a computer program that will identify all those individuals who are slow, or one step behind, in returning these cards to the exchange.

Once these people have been identified, fines will be levied. And I not only believe that 90 percent would be achievable; but we sincerely believe that more than 90 percent, and possibly closer to 95, may be a valid objective at some period of time in the future.

The **Chairman**. Mr. Fink, is 90 percent doable?

Mr. **Fink**. Mr. Chairman, I think we are within inches of 90 percent as we speak. 90 percent is the initial goal. We are, as I pointed out in my testimony, beginning a program to upgrade that performance using quick and very noticeable sanctions as the centerpiece of our effort.

I would like to point out, Mr. Chairman, that our time recordation system requires the actual manual recordation of trades within a one-minute time period of execution, and does not rely on any imputed method of calculating the correspondence between the trade register and the actual trade that takes place.

I think that is probably the most accurate way of measuring when a trade took place, and whether it took place at competitive prices. There is no doubt in my mind that the 90 percent initial goal is a piece of cake; and I expect that we will be able to move well beyond it in the near future, once our program gets its wheels on the ground.

The **Chairman**. Mr. Melamed, is it a piece of cake at the Merc?

Mr. **Melamed**. I do not know about the cake. We can achieve 90 percent. That is the minimum goal we have.

The **Chairman**. I have other questions on this issue, which I will submit for the record.

One issue that we hear, individual members of this committee, is that of self-regulation. When you talk about self-regulation, the obvious question the public asks is, if there is self-regulation and something goes wrong, if somebody breaks the rules, what happens to them?

The basic issue is, have the exchanges been tough enough in applying trading rules against their own members? So let us start with the Chicago Board of Trade. I asked the CFTC at our hearing a few weeks ago what has been going on. We have a chart over here, in the middle of these bookcases. [Indicating.] This chart shows the monetary sanctions imposed by the exchanges for trade practice violations during 1986, 1987, and 1988. [See page 188 for the chart.]

Now, according to the CFTC, the Chicago Board of Trade assessed far less in monetary penalties against members for trading violations from 1986 to 1988 than did the Merc; in fact, less than 40 percent as much in 1988; despite the fact that the Board of Trade's trading volume is about 80 percent bigger.

At the same time, the Mid-America Commodity Exchange, which is a major Board of Trade subunit, apparently had no fines at all for trading violations in 1987–1988. I mention Mid-America because they had a trading volume larger than many markets.

Now, the GAO data show the same patterns: Board of Trade penalties, being lighter than the Merc's. Does that mean that there were no violations there, or does it mean that the Board of Trade was lax in disciplining its members?

Mr. Mahlmann. Mr. Chairman, if I have your permission, out of our written statement, I excerpted one page. If I could get the summary out for the committee members?

The Chairman. Sure.

Mr. Mahlmann. The data reflected on your sheet was gained by the GAO on a very short order. It is incomplete. And our written statement contains a more complete record. From what I see up there, even the trading volume by the exchanges is not correct. So they are, I think, incomplete data.

If I can bring you up to date on 1988 by itself. The Board of Trade, Office of Investigations and Audits, started 1,464 trade practice inquiries. Of those 1,464 practice inquiries, 977 were generated by our computerized surveillance system. Out of those, 53 sanctions occurred out of those investigations; 53 cases where parties were found to have violated our exchange rules.

The resulting fines that came out of that were $1,450,000. The suspensions that came out of those 53 cases totaled 17 years; in addition to that, there was one expulsion for life. So I submit, Mr. Chairman, to you and this committee—and I understand that GAO is working at summarizing the data better for the next appearance of GAO before this committee—that this data is incomplete.

The Chairman. The one in the middle is from the CFTC. That is Dr. Gramm's public testimony on March 9. Now, according to her testimony, the Board of Trade had sanctions in 1986 of $180,000, in 1987 of $90,000, and in 1988 of $287,000. So just taking that, Dr. Gramm says $287,000 in 1988; but you say it was $1,450,000.

Mr. Mahlmann. Mr. Chairman, the difference is the accounting principle of cash, vis-a-vis accrual. When a trade practice inquiry is started in 1988, it may not be adjudicated until 1989. Some of the cases are started late in the year. They carry over into the following year. In some of them, additional information has to be garnered by our investigative staff.

The Chairman. But I want to make sure I fully understand, because they are such wide, variant numbers. I want to make sure we are using the accurate numbers. Dr. Gramm said trade practice violations, in 1988, resulted in $287,000 in sanctions. Are you saying that trade practice violations resulted in $1,450,000 in 1988?

Mr. Mahlmann. Yes, I am.

The Chairman. These are trade practices? This is not somebody who punches somebody out in the washroom or something like that? I mean, these are trade practice?

Mr. Mahlmann. Trade practice violations. The summary—and it is in our written submission statement.

The Chairman. What about these other figures you see up here for 1986 and 1987? Are those accurate, $180,000 and $190,000, and some change?

Mr. Mahlmann. We have disparity in those figures, too. They are not totally reflective of the record.

The Chairman. I would appreciate it if we could check with you and get your actual figures, because I would be concerned about the reasons for the discrepancy. Are those close to your actual figures?

Mr. **Mahlmann**. No. Mr. Chairman, we are correlating with the GAO in an ongoing dialog so that they will have the accurate figure for the next appearance before this committee for you.

The **Chairman**. Any idea why they would be so different?

Mr. **Mahlmann**. There was a very narrow interpretation taken at the original question of the GAO, when they came to the exchange, of trade practices; and they only covered one trade practice violation.

The **Chairman**. Which was what?

Mr. **Mahlmann**. Which was wash trading.

The **Chairman**. Does the Board of Trade have a problem with trade practices?

Mr. **Mahlmann**. Senator, the Board of Trade is vigorously committed to enforcing all of its rules. If I can give you, for the committee's benefit, one second's worth of briefing on how we develop a case?

Out of the 1,464 trade inquiries that you see, out of our 1988 summary sheet, those are prepared by a professional staff that has just been expanded by over 20 percent, and now has almost 110 people. And as you see, most of the increase was generated out of the computerized surveillance system. When that is triggered, our professional staff goes into the member firms that cleared the respective trades, gets the document data in hard copy now, and in original form, and establishes an inquiry file.

If they see any reason that the original inquiry has merit, they could substantiate the whole file and bring it to the membership committee as a completed file, with a recommendation from this professional OIA staff—Office of Investigations and Audits—to the members' committee, of charges to be filed. In most cases, when the staff has recommended the filing of charges, the committee has in almost all cases filed those charges. And in almost all cases, the committee then has found a guilty finding against that member.

The **Chairman**. We will have followup questions on this, because I still have a problem. I want to make sure that the same questions and same standards are being used by CFTC. If the GAO's numbers are wrong, or CFTC's numbers are wrong, then this committee is going to have a difficult time figuring out whose numbers to rely on in making a decision. One of the reasons for having these hearings is so you can look at them.

If I could go to NYMEX, we will look at the CFTC information on them. It shows that in 1986, there were $95,000 in trade practice sanctions; zero in 1987, and $32,500 in 1988. That would be a lot less than two other New York exchanges, the COMEX and the Coffee, Sugar and Cocoa Exchange, which actually have less volume.

Are those numbers correct, Mr. Guttman?

Mr. **Guttman**. Not entirely, Mr. Chairman. Our records indicate that in 1985, though it is not on the screen there, that a total of $145,000 in trade practice fines—two withdrawals of membership—and in 1986, our records indicate a total of $131,000 of fines, with a total of 10 months-worth of suspensions.

In 1988, we did have $32,500 in trade surveillance fines. But I would like to add that there was another $77,500-worth of penalties that were penalized against individuals with audit trail-related violations.

The floor committee on our exchange is a body of monitors who monitor the activity in the trading pit, who have the power to fine up to $5,000 per violation on a summary judgment basis, which does not even have to come before the compliance and disciplinary committees for adjudication.

In 1988, we had a total of $120,000 in these floor fines, which I do submit are disruptive trading fines and decorum. In 1987, the particular year, Mr. Chairman, you are targeting in on, that year has to be placed into perspective to our whole broad compliance picture. In fact, the Compliance Department had $250,000-worth of sanctions, with a 1 year of withdrawal of membership, and one permanent withdrawal of membership.

Now, of course, the result of these compliance actions were for financial surveillance and market surveillance that have a direct benefit to the public customer. In that year, in 1987, the floor committee levied a total of $85,000 in fines; again, in a summary manner, without the disciplinary process for disruptive trading practices and decorum.

That same year, the Compliance Department, through the Business Conduct Committee, issued 12 warning letters to individuals, which became part of the permanent record of their regulatory broker profile. Therefore, I would like to submit, Mr. Chairman, that the absence of a specific trade practice fine that year is not indicative of the entire exchange's compliance program.

Also, computer implementations and software, as I indicated in my opening statement, went into effect in the latter part of 1988. I would like to point out that the surveillance aspects and cases that were commenced in 1988, up to this first quarter of 1989, have already resulted in $52,000 in fines, a 3-month suspension and further withdrawals of membership.

In 1989, our enhanced surveillance system has already generated 65 investigations; 7 cases were brought to the attention of the Business Conduct Committee; 4 resulting in final disciplinary actions. I would like to submit these numbers to add to the overall perspective, Mr. Chairman, and so be considered.

The CHAIRMAN. Good. In 1987 you also had a problem where your vice president, who was in charge of the compliance, resigned over a question of conflict of interest; did he not?

Mr. GUTTMAN. That was the year, sir.

The CHAIRMAN. As for the Chicago Merc—we will go to them—a Wall Street Journal article last January described the Merc's Japanese yen trading pit as "the boxing ring." The article stated it was characterized by "pushing, shoving and elbowing." And it said "the yen pit had a reputation on the floor for 'sloppy trades' that cost customers money."

The article quoted a senior officer of a Merc member firm—they never identify him other than that—saying "the yen and the Swiss [franc] pits have traditionally been very dirty pits, where some traders are more willing to try to skim some profits off of trades. The theory is, you are dealing with banks, so what is a lousy tick or two?"

I will put that article in the record.

[The Wall Street Journal article follows:]

[The Wall Street Journal, January 26, 1989]

PROBE OF 2 EXCHANGES SHOWS WILD FRATERNITY OF TRADERS IN YEN PIT

FLASHY AND RAUCUS, THEY SEEK QUICK PROFIT IN MARKETS SOME CONSIDER 'DIRTY'

NEW DRINK: SUBPOENA COLADA

(By SCOTT MCMURRAY and JOHN KOTEN, Staff Reporters of the Wall Street Journal)

CHICAGO—One trader at the Chicago Mercantile Exchange refers to the pit where Japanese yen futures are traded as "the boxing ring." Pushing, shoving and elbowing—it's how the 65 traders in the tumultuous yen pit put in a day's work.

In more heated moments, traders have had to dive in to pull apart combating colleagues. Last year, after a brawl in which one trader's nose was smashed, the exchange's enforcement department sent an employee to monitor the yen pit on a regular basis. Several disciplinary actions were taken.

But now the Chicago Merc is probably wishing it had sent down a different type of cop. For in recent days, the Japanese yen pit has emerged as the primary target of Operation Hedgeclipper—a two-year government sting operation aimed at uncovering fraud in Chicago's futures industry.

In fact, while a number of trading pits at the Chicago Merc and the Chicago Board of Trade have been identified as subjects of a broad investigation, the most serious allegations that have come to light involve the yen pit.

The Triathlete

The pit is composed of an oddball collection of people—including lawyers, doctors, a bowler, a triathlon athlete and a trader obsessed with his business he never took restroom breaks. It has produced government findings that may have serious consequences for the Merc.

One potentially vulnerable target may be the extremely powerful brokers associations on the floor, which act something like partnerships and employ or trade actively with dozens of traders in nearly every pit on the exchange. The government is understood to be pursuing possible racketeering charges against exchange traders. The associations' large network of traders may make it possible for the government to demonstrate a pattern of collusion to defraud customers. So far, though, allegations of collusion haven't emerged

In the yen pit itself, more than a dozen traders are believed to be targets of the government's investigation. One of these traders is Sam Cali, a member of the largest broker association on the floor and a former member of the yen-pit committee, which arbitrates trader disputes. Mr. Cali declined comment on the investigation.

'The Breakfast Club'

Some brokers under investigation in the yen pit make seven-figure incomes and have powerful connections throughout the Merc. This may put them in the best position to help federal authorities carry their investigation—the most ambitious ever of the futures industry—to higher-placed officials at Merc member firms.

Yen-pit brokers already identified as targets of the investigation include David Horberg, a millionaire broker and a former member of the yen-pit committee, and John Baker, another broker who normally stood near. Mr. Horberg in the trading area. They and other brokers ate many mornings with a man who turned out to be an undercover FBI investigator. Some traders labeled the gathering "The Breakfast Club."

At least one trader in the yen pit allegedly was "turned" into a government informant by investigators last year and has worn a hidden microphone to try to gather incriminating evidence against fellow traders.

Now some of these and other brokers nervously gather after hours at the bar in the Merc's members-only club one level below the trading floor. Their favorite drink? "Subpoena colada," jokes one Merc member. The traders in the yen pit have always had a penchant for schoolyard pranks, pinning labels on each other's backs saying things like "Loves Prison Sex." Yesterday, a trader pinned a label on a buddy, but this time it said: "FBI."

Suspect Pits

The yen pit had a reputation on the floor for "sloppy trades" that cost customers money, traders say. But some in the industry are even harsher in their judgment of the pit: "The yen and the Swiss [franc] pits have traditionally been very dirty pits," says a senior officer of a Merc member firm who also owns a seat on the board of trade.

He says abusive trading practices in the yen pit gathered steam after the stock-market crash of October 1987. Stock-index futures trading volume had fallen about 40 percent at the Chicago Merc, so several traders from the Merc's raucous Standard & Poor's 500 stock-index futures pit migrated to the yen pit, the official of the member firm says.

"The word was these guys carried the S&P virus into the yen pit," he says.

Responding to widespread customer criticism, the Chicago Merc did make an effort to clean up trading practices in the S&P 500 pit over the past two years, where customers assert that traders were skimming thousands of dollars of profits off trades. They allegedly did this by trading with another broker at one price and charging a customer a higher price. But the yen pit apparently wasn't subjected to such scrutiny from the exchange.

Traders have sought out the quick profits of the yen pit, and other financial futures contracts, since currency futures trading started on the Chicago Merc in 1972. Big banks are one of their largest customers, but smaller businesses also wade into the pits to "hedge" their foreign-currency-denominated holdings. Here's how a yen trade might work:

A food exporter in California ships $100,000 in canned corn to Tokyo, where he will be paid in yen. If, however, the yen plunges 5 percent against the dollar between the time he prices the shipment and collects payment, he could lose $5,000 and likely post a dollar loss on the deal.

To guard against that, the exporter asks his broker to sell one contract covering future delivery of 12.5 million yen—roughly $100,000 worth, at current exchange rates. The contract provides a hedge by enabling the exporter to collect a profit if the yen should fall. Thus, any loss on the shipment of canned corn is offset by the profit on the futures contract.

One trader in the pit, meanwhile, makes a commission on the shippers contract. Another bets on bigger profit by taking the other side of the exporter's trade, and hoping he can make money on moment to moment price swings in the contract's price. He doesn't care about long-term fluctuations. Banks also frequently speculate on short-term shifts.

Traders say that, because the public is rarely represented in the pit, some yen futures traders are more willing to try to skim some profit off of trades.

"The theory is you're dealing with banks, so what's a lousy tick or two?" said one Merc member. A "tick" is trading floor argot for the smallest increment a futures contract can trade up or down and, in yen futures, equals $25 a contract. So far, customers, including the large banks that order up trades, haven't complained about the alleged fraudulent futures trading.

The yen pit is an arcane spinoff of the huge international foreign-exchange market. The Merc's daily yen futures volume of contracts covers about $2 billion and is dwarfed by the estimated $250 billion traded each day world-wide in the interbank currency market. Of course, most of the traders and brokers in Chicago's yen and other futures pits are honest individuals willing to take big financial risks for potentially huge gains. But the focus now is on several of their colleagues who have attracted the attention of the FBI.

Several people on the Merc floor said they regarded many of the yen-pit traders as nice guys. "Dave Horberg is one of the sweetest people I know," said one trader. He noted that Mr. Horberg keeps Jolly Rancher candies in his pockets, and hands them out frequently to other traders and floor runners.

Jim Baker, a yen-pit trader, arrived at work every day wearing an assortment of goofy polka-dot ties, Hawaiian jackets, Florida prints, loud sport coats and plaid pants. He employed three sons in his trading firm. His telephone answering machine features Daffy Duck.

Another yen-pit trader, Dennis Teven, whom other traders say received a government subpoena, wore an official identification badge: "D-DAY." Other badges in the pit include "POP," "WOW," and "CHI-CHI." Mr. Teven couldn't be reached for comment.

Within the pit, there are a number of tightknit groups, whose members have often operated as allies on the floor. They eat lunch together, play golf together and trade with each other. Mr. Horberg car pooled to work each day from Chicago's northern suburbs with two other yen-pit traders: Brad and Steve Wulfsohn. Their trading spot is in front of Mr. Horberg in the yen pit.

Steve Wulfsohn received a subpoena Monday night from investigators. He couldn't be reached yesterday, and his brother declined comment.

Mr. Horberg, whom traders say is in his early 40s and has sandy hair and round features, was one of the leading players in the pit, trading at least 5,000 contracts a day, worth $1.25 a contract in commissions. Mr. Horberg handled buy and sell orders for several large financial institutions trading currency futures, and processed his trades through Dellsher Investment Co. Dellsher is owned by Leo Melamed, the powerful chairman of the Merc's executive committee. On Monday, Dellsher informed Mr. Horberg it would no longer handle his trades.

He apparently has been unable to find another firm to handle that work, which has kept him off the floor and has angered other traders. "Horberg hasn't been proven guilty of anything, hasn't even been indicted and he's already lost his livelihood," one broker said. "I think that stinks." Mr. Horberg couldn't be reached for comment.

The pit's reputation for sloppy trades, however, may have been the reason that the undercover agents moved their activities from the S&P pit into the yen pit. The two undercover agents, known as Peter Vogel and Randy Jackson, shared office suite 1208 at the Mercantile exchange, where they supposedly operated a company called Dolphin Trading International Ltd. (A small green dolphin decorates the door into their office.) They also kept apartments at the nearby Presidential Towers housing complex.

Their activities suggested the government spared no expense in its pursuit of futures trading fraud. The government spent more than $1 million buying seats on both exchanges for its moles to use in trading.

In addition to living in luxury apartments, the moles also bought memberships at the Tony East Bank health club just north of Chicago's Loop business district and at least one or two of them were seen by traders driving Mercedes Benz luxury cars around Chicago.

During his two-year stay at the exchange, Mr. Vogel told traders he owned a private corporation that was losing money and thus could take their winning trades on his books, avoiding taxes.

Under the scheme, the traders would direct profitable trades to Mr. Vogel while they would accept losing trades into their account. The mole then paid them illegally in cash-filled envelopes to make up for the losing trade. The result: a fat profit, hidden from the Internal Revenue Service. Some of these payoffs apparently were recorded on videotape.

The moles also are said to have accumulated evidence of traders buying and selling contracts between themselves without trying to get the best price available in the pit; trading ahead of large customer orders to profit from these orders' market impact; and making other non-competitive trades.

Since word of the federal investigation leaked last week, the ranks of the traders in the yen pit has thinned. In the last few days, about 10 to 12 traders have been missing from the pit each day. Volume also has been off some.

"It's a grim atmosphere over here," says one yen-pit trader. "What the heck would you expect?"

The Chairman. Right or wrong on that portrayal?

Mr. Melamed. Wrong.

The Chairman. The CME shows—again, if these figures are right—a big increase in penalties assessed in 1987. Fines increased 5-fold; from $313,000 in 1986 to about $1,700,000 in 1987; suspensions increased 48-fold, from 238 days in 1986 to 12,392 days in 1987.

Are those numbers about accurate in showing a substantial increase in suspensions and fines?

Mr. Melamed. They are correct.

The Chairman. What caused that sudden jump?

Mr. Melamed. As I described in my opening statement, and as my written testimony indicates, we have a continuing program of upgrading the disciplinary procedures of our exchange, as well as a tougher and tougher policy with respect to fines, and violations, and surveillance. And these are the results of that continuing policy.

The **Chairman**. And the last question in my round on this issue—I will have others afterward—is, of course, for COMEX. According, again, to the CFTC chart, numbers of which have been disputed, the level of trading abuse fines which you have imposed appears very high, about 20 times as great as what NYMEX shows and twice as great as the Chicago Board of Trade. I understand we have a question on the NYMEX numbers and Mr. Mahlmann has suggested that the CBT numbers may be wrong. Your trading volume, though, is far smaller than either of these markets. Is your trade volume quite a bit smaller?

Mr. **Fink**. Significantly smaller; yes.

The **Chairman**. First off, let me ask you about the numbers that are shown here for COMEX. Are those numbers correct?

Mr. **Fink**. We have had some discussions with the CFTC concerning discrepancies in the data; but definitely none involving the orders of magnitude that are being suggested here. To be specific, if I may, Mr. Chairman.

The **Chairman**. Sure. Oh, yes.

Mr. **Fink**. I think the 1986 figure, it has been mutually agreed, is off by approximately $250,000. The CFTC underestimated that figure.

The **Chairman**. So you would be up close to the $700,000?

Mr. **Fink**. It would be higher in that 1987.

The **Chairman**. 1987, rather. So, for 1987, you would be around a little over $800,000, is that correct?

Mr. **Fink**. The correct numbers, according to COMEX, Mr. Chairman, are $622,500 in 1988, $701,000 in 1987 and $428,800 in 1988. If that is what it says on the chart, then I am sorry, because I cannot quite see it.

The **Chairman**. Wait a minute. Now we are getting confusion the other way. Let us start with 1986. What do you show for 1986?

Mr. **Fink**. $428,800.

The **Chairman**. What do you show for 1987?

Mr. **Fink**. $701,000.

The **Chairman**. And what do you show for 1988?

Mr. **Fink**. $622,500.

The **Chairman**. In any event, based on your volume, this seems to be a fairly significant penalty rate. Do their numbers show just that you are particularly tough on members, that your fines are particularly tough? Or have you had an awful lot of problems?

Mr. **Fink**. I suppose one could reach the conclusion that we have more problems than others, but I think that would be——

The **Chairman**. I do not mean that as a stop-beating-your-partner kind of question. What does it reflect?

Mr. **Fink**. I think it reflects a commitment that we made at least 6 or 7 years ago, to establish compliance as an important part of our product area. It represents the use of very effective and professional compliance staff. It represents the very effective watch-work of the Board of Governors which, from time to time, has questioned sanctions against members and chose to put down new directions of sanctions by suggesting that they be elevated.

It suggests in general, Mr. Chairman, a serious commitment to solving these kinds of problems at the exchange.

The **Chairman**. Thank you, Mr. Fink. I appreciate my colleagues' allowing me to go a little bit over my time on this. Because of the charts and because there has been some dispute of these numbers, I want everybody to have a chance to refer to them.

As I announced at the beginning of this hearing, we would take Senators in the order in which they came in. That would have been Mr. Baucus first. He has left for another hearing that he is required to attend. Senator Kerrey, then, would be next.

Senator **Kerrey**. Thank you, Mr. Chairman. I do have a full statement that I would submit for the record, as well as some other questions.

The **Chairman**. Without objection.

[See the contents for the prepared statement and questions of Senator Kerrey.]

STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator **Kerrey**. On Monday, the President announced a major effort to combat crime in the United States of America. In explaining the administration's policy, the Attorney General of the United States of America, Dick Thornburgh, indicated that there are basically five dimensions to the policy. And I say this for the purpose of making you understand where my attention for the moment is directed.

The first area is the law itself. The Attorney General said we are going to send a message out to the criminals of this land that we are going to have tough laws.

The second area dealt with making sure that law enforcement people capture and isolate the individuals from society who have broken the law.

The third area, he said, is prosecution. And this element, the Attorney General of the United States of America said, will send a message that if you break the law, you are going to be prosecuted.

The fourth level is sentencing. And the Attorney General of the United States of America said the message should go out loud and clear that, if you are prosecuted successfully, you are going to be sentenced.

The fifth area that the Attorney General identified is punishment. The Attorney General said let the word go out that if you are sentenced, you will do time. You will be punished.

I like the message that he sent to the people of this Nation. I have not investigated all the details of the proposal, but the underlying assumptions, I think, are sound. I lay that out because what we have done here thus far is focus a lot of attention on the laws themselves. You have made some proposals as to how we ought to change the laws, and the various devices to catch individuals.

But my concern is, not only the prosecution and the capacity to prosecute, but the willingness to sentence, and finally, the intensity of effort to carry that sentence out. My fundamental assumption is that I believe the Government of the United States should pursue fraud in the commodities market with at least the same intensity that it pursues people who have unpaid student loans, or people who have been overpaid advanced deficiency payments for corn. We should pursue commodities trading fraud with at least that intensity.

I have talked to at least two of you here about this. I think the message that is going out right now to crooks and swindlers, based on the amount of uncollected fines levied by the CFTC, is that the odds are in your favor not to have to pay a fine. I believe that message is going out. And I offer to the committee, and I offer to you, the CFTC's own record of uncollected fines that have been turned over to the U.S. Department of Justice for collection. Within the past 10 years, $12 million worth of fines have not been collected out of $24 million that has been levied. There is $4 million that is still on the books that the Justice Department is trying to collect, but the rest has apparently been written off.

The CFTC and the Justice Department have begun, I think, to do some things to improve the situation. But I would suggest that the evidence still seems to indicate that the odds are on the side of individuals who say, well, let us run the risk and break the law. That is how it appears to me. I want to make that clear at the start, because I know that you are not only here representing yourself, but you have members out there. And I want them to get the message that that is the perception that I have, looking at the evidence.

I want it to be made clear, when you go back to your members, that Senator Kerrey of Nebraska looks at the evidence and is not persuaded that the necessary prosecution is being done, or that the sentencing is being done, or that a good faith effort is being made to collect the fines.

I would like to ask, and I know it cannot be done here this morning, but I would like to ask each exchange to provide me with information on the collection rate of fines for each of your exchanges over the last 5 years. I want to know how successful you have been. I assume you cannot do that here this morning.

[The fine collection rate information follows:]

June 16, 1989.

MS. CHRISTINE SARCONE,
Chief Clerk, Senate Committee on Agriculture, Nutrition, and Forestry, 328-A Russell Senate Office Building, Washington, DC.

DEAR MS. SARCONE: Enclosed herewith is the information that Senator Kerrey requested during hearing before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry on Wednesday, May 17, 1989. Thank you for allowing us an extension of time for the submission of this information.

Exhibit A contains a summary of fines for violations of compliance rules, clearing firm requirements (generally, for late submission of data and related reporting requirements), and dress, conduct and other administrative rules. The total fines assessed for each year have been broken down by waived fines, suspended fines, and collected and uncollected fines as of May 31, 1989, for the years 1984 through 1988.

Exhibit B contains an explanation as to why material fines remain uncollected.

If you have any questions regarding the enclosed, please do not hesitate to call me.

Very truly yours,

GERALD D. BEYER.

Enclosures.

EXHIBIT A—CHICAGO MERCANTILE EXCHANGE SUMMARY OF FINES 1984 THROUGH 1988

	1988 amount	Percent	1987 amount	Percent	1986 amount	Percent	1985 amount	Percent	1984 amount	Percent
Compliance	$1,119,950	63.5	$2,265,304	67.6	$1,130,950	57.5	$727,200	49.1	$200,225	27.1
Clearing firm	565,405	32.1	826,426	24.7	600,923	30.5	413,940	28.0	258,956	35.1
Dress, conduct and other administrative fines	77,235	4.4	257,694	7.7	235,912	12.0	338,509	22.9	279,459	37.8
Total assessed	1,762,590	100.0	3,349,424	100.0	1,967,785	100.0	1,479,649	100.0	738,640	100.0
Fines waived [1]	113,000	6.4	45,000	1.4	0	0.0	59,700	4.0	0	0.0
Suspended fines [2]	0	0.0	0	0.0	50,000	2.5	135,000	9.1	0	0.0
Amount collected	1,422,710	80.7	2,767,323	82.6	1,453,785	73.9	1,204,449	81.4	738,640	100.0
Uncollected as of 5/31/89 [3]	226,880	12.9	537,101	16.0	464,000	23.6	80,500	5.5	0	0.0

[1] Waived fines: Fines which a committee has assessed, but waived if the subject remains in compliance with exchange rules for a period of time after the date of the fine. A committee may waive a portion of the fine, it believes the person's or firm's conduct was not intentional or if the person or firm had already taken steps to correct the situation which led to the violative conduct.

[2] Suspended fines: Fines which a committee assessed, but decided to make payable upon the return of the violator. In some cases, the person fined has little or no funds. Instead of pursuing other legal means to collect the funds, the committee will make the fine payable upon reapplication of the violator, which in effect will preclude his or her return here or at any other exchange.

[3] See attached for explanation.

EXHIBIT B—EXPLANATION OF UNCOLLECTED MATERIAL FINES

1985

Of the $80,500 in uncollected fines:

$77,500 was assessed against seven account executives who were non-members and who were employed in the same branch office of a member firm. While the Exchange fined the principals of the firm and the firm itself, it did not, although it could have, assess the firm for the unpaid fines of these seven salespeople. The names of the account executives were furnished to the National Futures Association (NFA), which would prohibit these individuals from re-entering the business.

1986

Of the $464,000 in uncollected fines:

$359,000 was assessed against four account executives who were non-members and who were employed in the same branch office of the firm mentioned above. Again, these individuals would have been reported to the NFA. As an aside, this firm is no longer in business.

$105,000 was assessed against a clerk who was a non-member at the time of the decision. He was discharged by the firm due to allegations of unauthorized trading. He had no job or assets to attach. The NFA would have been notified of the actions taken.

1987

Of the $537,000 in uncollected fines:

$125,000 was assessed against a non-member who filed for bankruptcy. The Committee expelled the individual from membership in the Exchange.

$100,000 was assessed against a member who was expelled from the Exchange. Because he was using a firm membership, the Exchange could have sought payment from the firm that was his employer; however, since the allegations made against him were that he had stolen money from his firm, the Exchange did not seek payment from the firm. As part of the Exchange action, he was ordered to make restitution to his firm and, of course, was expelled from the Exchange. As an aside, he has also served a jail sentence as a result of subsequent federal prosecutions for these violations.

$110,500 is the approximate remaining unpaid amount from a settlement offer, which included a $500,000 fine. At the time of the settlement, the membership was worth approximately $500,000; however, because of a drop in price, the membership was sold for substantially less, leaving the Exchange with an amount due. The remaining unpaid fine has been turned over to outside counsel for collection.

$150,000 was assessed against three individuals who were non-members at the time of the decision. There were no assets to attach, but the fines will act as bar to the return of the three individuals to the industry.

$45,833 is the balance of a $50,000 fine assessed against a current member, who may not return to the Exchange floor until the fine is paid in full. No decision has been made at this time to sell the membership.

1988

Of the $226,880 in uncollected fines:

$120,000 was assessed against a member leasing a seat. At the time of the hearing, the individual was a clerk at the Exchange and had no assets to attach. Although we have the authority to attach the membership of the lessor, we did not because he was not culpable.

$20,000 was assessed against another individual who was a clerk at the Exchange. The fine is a bar preventing him from returning to the Exchange floor for a period of 5 years from the date of payment of the fine. The individual had no apparent assets to attach.

$60,000 was assessed against two individuals who were non-members at the time of decision. Neither had a permanent job or assets to attach. The Exchange does not believe that legal proceedings would be worthwhile.

$10,000 was assessed against a clerk to bar him from returning to the Exchange trading floor in any capacity. Again, legal proceedings were not warranted.

CBOT FINE COLLECTION HISTORY

[By Calendar Year of Collection]

	Collected	Outstanding
1984	$157,225	$0
1985	451,650	0
1986	309,153	0
1987	447,950	0
1988	204,000	0
1989 (Levied through June 30.)	268,700	[1] 1,180,000

[1] Three traders have not yet paid fines of $5,000, $50,000 and $1.125 million in 1989.

NEW YORK MERCANTILE EXCHANGE,
OFFICE OF THE CHAIRMAN,
July 10, 1989.

VIA FEDERAL EXPRESS

The Honorable PATRICK J. LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, SR-328A Russell Senate Office Building, Washington, DC.
ATTN: Betsy Paul.

DEAR CHAIRMAN LEAHY: Attached, in response to the inquiry by Senator Kerrey, please find a schedule detailing the fines imposed and collected by the New York Mercantile Exchange during the period from 1984 through 1988.

There are several important notes that should be clear in connection with your review of this information. First, with respect to the summary action fines for unreturned transfers and speculative limit violations, you should be aware that these rules did not go into effect until 1987 and 1988 respectively. Therefore, there are no fine amounts for prior years. With respect to Floor Committee fines, as I testified on May 17, these cover, among other things, decorum and disruptive trading practices. Finally, the Compliance Department fines cover cases presented to a disciplinary and/or delivery committee.

All fines are encompassed in the Exchange's rules governing non-payment which may result in suspension and/or expulsion. For the period in question, there are no records indicating the need to invoke these provisions with respect to any Compliance Department actions.

If you have any further questions or need additional answers, please do not hesitate to contact the undersigned.

Very truly yours,

Z. Lou Guttman.

[Response to the inquiry by Senator Kerrey follows:]

NEW YORK MERCANTILE EXCHANGE—SUMMARY OF FINES IMPOSED AND COLLECTED [1]

	1984		1985		1986		1987		1988	
	Imposed	Collected	Imposed	Collected	Imposed	Collected	Imposed	Collected	Imposed	Collected
Compliance Department—disciplinary cases	$167,600	$167,600	$85,000	$85,000	$259,000	$259,000	$233,500	$233,500	$368,500	$368,500
Floor Committee—summary actions	19,050	19,000	28,000	28,000	35,050	33,900	81,450	77,450	116,450	115,450
Unreturned Transfers—summary actions	NA.	NA.	NA.	NA.	NA.	NA.	4,700	4,600	14,100	14,100
Speculative Limits—summary actions	NA.	NA.	NA.	NA.	NA.	NA.	NA.	NA.	6,500	6,500

[1] See notes in accompanying letter.

Commodity Exchange, Inc.,
Washington, DC., *June 23, 1989.*

Kenneth D. Ackerman, Esq.,
Special Counsel, U.S. Senate Committee on Agriculture, Nutrition, and Forestry, SD-647, Dirksen Senate Office Building, Washington, DC.

Dear Mr. Ackerman: As requested in your letter of June 9, attached is the data on unpaid sanctions at COMEX.

I hope this information will serve your purpose. If we can be of further help to the Committee in efforts toward reauthorization of the CFTC, please call me.

Sincerely,

Stephen E. Storch,
Vice President, Government Affairs.

Attachment.

Commodity Exchange, Inc.,
New York, NY, *June 22, 1989.*

Steven E. Storch, Esq.,
Vice President, Commodity Exchange, Inc., 1331 Pennsylvania Avenue, NW., Suite 550, Washington, DC.

Dear Steve: In conjunction with your request, I have reviewed our files for any unpaid sanctions in recent years relating to floor trading abuse.

I have identified two sanctions, one each for 1987 and 1988, which have not been paid: a $10,000 fine issued in 1987, and a $50,000 fine issued in 1988. Both of these sanctions were imposed on individuals who were members at the time of their violative acts, but who have subsequently terminated their memberships.

Very truly yours,

James E. Goodwin,
Senior Vice President.

Senator **Kerrey**. I would like to open up one case that we discussed in a previous committee hearing and that is the *Sanders* case that was prosecuted. I have talked to the Board of Trade people about it and I have talked, as well, to Judge Aspen, who tried the case.

Judge Aspen made a comment after hearing evidence for 3 weeks from the four defendants and six other people who offered additional testimony. He concluded that there is a "cess-pool of corruption" now at the exchange. He has indicated himself that that remark was taken a bit out of context.

But he said to me, in a phone conversation this morning, something that seems, at least, to contradict not only what, Mr. Mahlmann, you are saying to me, but also what I am getting from the CFTC itself. He said that the United States Attorney indicated that the case was dead in the water; that it would not have gone forward had not a pang of conscience hit one of the individuals, who walked into the FBI office and said, "I am willing to provide evidence in this particular case so that it can move forward."

That is the indication, apparently, that the U.S. Attorney made at the time of sentencing. I would like to ask, Mr. Mahlmann, when the CFTC says that the Chicago Board of Trade immediately commenced its own internal investigation upon being approached by a floor member, what shape did your internal investigation take? How do you internally investigate situations like this, and in particular, what sort of internal investigation did you do in this case?

Mr. **Mahlmann**. Senator, we immediately, upon the notification by the member that it appeared like an opposite member had walked away from the trade and was not available to clear this trade this next morning, we started instantly our own investigation as to who the other party could be, meaning checking floor orders, checking clearing records.

Senator **Kerrey**. Excuse me, can you get fairly specific? I mean, when you do an investigation, what sort of people; what sort of training; what sort of skills do they have; how many individuals did you actually put on the case?

Mr. **Mahlmann**. We have an Office of Investigations and Audits comprised of, now, about 108 people. The department just underwent a 20 percent increase in staff. Those people are professionally trained. We have expanded the professional training over the last few months. These people are professional investigators. They are permanent staff of the Board of Trade. They are not members.

Those people go into the member firms to try and gain the underlying records to trades. In this case, it was trades that somebody had walked away from and others that somebody had reallocated to various accounts. We could not find the ultimate member, or ultimate party, amongst our members and employees. When we were stymied because it appeared to go outside of the exchange's wall—when we were stymied in our investigations—did our then chairman and our president, who is still president, Tom Donovan, walk over to the U.S. Attorney's office and present him with a case and the facts that we had in hand; and told him that it gave the appearance that it was perpetrated by a party not within the exchange, but from without—not a member, not an employee, not a member firm.

The party happened to be knowledgeable with customs and practices in order to effect that. But it was our people that walked into the U.S. Attorney's office and reported the case. And I would like to present to the committee——

Senator **Kerrey**. Do you accept Judge Aspen's representation that Mr. Valukas stated that the case itself was dead in the water?

Mr. **Mahlmann**. I would like to submit, to answer that question for the committee, with the chairman's permission, a letter dated November 21, 1988, addressed to Thomas Donovan, chairman, over the signature of Anton Valukas.

With the chairman's permission, I would like to read the letter into the record.

The **Chairman**. Without objection.

Mr. **Mahlmann**. "On November 3, 1988 Thompson B. Sanders was sentenced to six years incarceration and a $300,000 fine by the Honorable Judge Marvin E. Aspen in federal court in Chicago, Illinois. That sentence resulted from Mr. Sanders' conviction by the federal jury in September, 1988 following a four-week trial. Mr. Sanders was convicted of masterminding a complex commodity scheme in which he and others executed deceptive trades at the Chicago Board of Trade by utilizing disguises.

"I would like to take this opportunity to thank you for bringing this matter promptly to the attention of my office. Because you brought the allegations of criminal activity to our office immediately after it was discovered on October 3"—and by the way, this is a misprint; it should read 1986—"the F.B.I. and the U.S. Attorney's Office were able to lay the groundwork for what eventually proved to be a successful prosecution.

"I would also like to thank your legal department for their invaluable assistance throughout the investigation in giving prompt attention to the innumerable document requests made by my office. I would also like to commend Scott Early"—I will add here, General Counsel, Board of Trade—"for his invaluable assistance in explaining commodities to co-prosecutors James M. Conway and Thomas M. Durkin and for testifying at trial. Mr. Early's testimony enabled the jury to comprehend many aspects of the commodities area in a sufficient manner which allowed them to convict Mr. Sanders. Please convey to Mr. Early our appreciation for a job well done. I speak for the entire prosecution team when I say that we are grateful for his help and look forward to working with Mr. Early in the future."

[The letter follows:]

U.S. Department of Justice,
United States Attorney,
Northern District of Illinois, November 21, 1988.

Thomas Donovan,
Chairman, Chicago Board of Trade, 141 W. Jackson, Chicago, Illinois.
Re: *United States* v. *Thompson B. Sanders,* 88 CR 104

Dear Mr. Donovan: On November 3, 1988 Thompson B. Sanders was sentenced to six years incarceration and a $300,000 fine by the Honorable Judge Marvin E. Aspen in federal court in Chicago, Illinois. That sentence resulted from Mr. Sanders' conviction by a federal jury in September, 1988 following a four-week trial. Mr. Sanders was convicted of masterminding a complex commodity scheme in which he and others executed deceptive trades at the Chicago Board of Trade by utilizing disguises.

I would like to take this opportunity to thank you for bringing this matter promptly to the attention of my office. Because you brought the allegations of criminal activity to our office immediately after it was discovered on October 3, 1988, [1986], the F.B.I. and the U.S. Attorney's Office were able to lay the groundwork for what eventually proved to be a successful prosecution.

I would also like to thank your legal department for their invaluable assistance throughout the investigation in giving prompt attention to the innumerable document requests made by my office. I would also like to commend Scott Early for his invaluable assistance in explaining commodities to co-prosecutors James M. Conway and Thomas M. Durkin and for testifying at [the] trial. Mr. Early's testimony enabled the jury to comprehend many aspects of the commodities area in a sufficient manner which allowed them to convict Mr. Sanders. Please convey to Mr. Early our appreciation for a job well done. I speak for the entire prosecution team when I say that we are grateful for his help and look forward to working with Mr. Early in the future.

Sincerely,

ANTON R. VALUKAS,
United States Attorney.

Senator **KERREY**. I appreciate you reading that into the record, Mr. Mahlmann. I do not want to get into a situation where I feel like I am attacking and you are defending.

I am trying, in fact, to discover what we need to do in order to facilitate prosecution, sentencing, and an appropriate judgment being collected from the individual after sentencing has occurred.

I am asking you, is it a proper representation of Judge Aspen's statement to me that, in fact, Anton Valukas said at the time of sentencing that this case was dead in the water; that had it not been for one of the individuals who got a pang of conscience and walked into the FBI office, nothing would likely have happened, perhaps because of the complexity of the case, perhaps because of other mitigating reasons? Is it an accurate representation of Valukas' statement at the time of sentencing that it took this individual walking in off the street and saying, "I've got a pang of conscience here, to bring the case to completion?"

Mr. **MAHLMANN**. Senator, I do not know. I was not there at the sentencing; but I think what we have to readdress again, it was not perpetrated by a member of the exchange.

Senator **KERREY**. But Mr. Mahlmann, that is not terribly encouraging. I mean, this guy obtained counterfeit floor jackets and counterfeit badges. He has four or five guys—accomplices and a fake beard with the rubber band showing—I get a picture of Woody Allen in the movie "Bananas." He came onto the floor with a group of people, and he perpetrated fraud.

Mr. **MAHLMANN**. But in order to address your points, we have the laws—we have very strong laws against any misdeeds on the exchange floor. We have a professional staff, if you want to equate that to the police force. We prosecute severely.

I explained before, when a professional staff brings to the member committee almost every case that the professional staff said, "charges should be filed," charges were filed. In almost every instance a sentence was rendered, and the penalty was pretty stiff.

We wholeheartedly corroborate the President's message that you are reiterating here this morning.

Senator **KERREY**. But I think the incentive is still there for the individual to commit fraud, judging from the Government's inability to collect fines. Clearly, we are not pursuing the collection of fines for commodities exchange fraud as intensely as we are pursuing fraud on student loans, or the overpayment of advanced deficiency payments to farmers. We are not pursuing commodities fraud with the same sort of vengeance, it seems to me.

The expulsion that you list here is Mr. Sanders, himself, who you expelled after he was in jail. I appreciate that that action was taken, but it was not until the man was serving time in prison that the expulsion occurred; not true?

Mr. **Mahlmann**. Senator, can I also put on the table a prior case that goes along your lines?

First Commodity Corporation of Boston was fined by the MidAmerica Commodity Exchange, and it is not in the figures reflected up there, $3.5 million.

I happen to be also chairman of the MidAmerica Commodity Exchange that rendered that verdict. That fine was collected and subsequently contributed to the class settlement for the benefit of the defrauded parties by the exchange.

We are very committed to collecting our fines.

Senator **Kerrey**. Well, I would like to see the record of collection over the last 5 years, because what I submitted for the record from the CFTC does not seem to indicate that.

The CFTC records of uncollected fines do not seem to indicate the intensity of effort that I think is required, if we are going to send a message out that the odds are against you if you choose to defraud and break the law.

One final question. Again in the *Sanders* case, and I am not trying to suggest that *Sanders* is the rule—obviously he is the exception—I am trying to understand the procedures you followed. Why in this particular case did you present to the U.S. Attorney's Office rather than to the CFTC the evidence at hand?

Earlier in questioning the CFTC, we questioned them about their capacity to police, to enforce, and to prosecute. Why was the contact made with U.S. Attorney Valukas instead of with Chairman Gramm?

Mr. **Mahlmann**. Senator, we took steps and went to Anton Valukas, the U.S. Attorney, because it went outside of our exchange. It went outside of our membership. It went outside of our member firms. Those are the entities over which we, as a self-regulatory organization, have jurisdiction, and we thought the appropriate place was the U.S. Attorney's office, because we thought fraud had been permitted and it is a criminal act.

Senator **Kerrey**. So had it been a member, you would have gone to the CFTC, not the U.S. Attorney's Office?

Mr. **Mahlmann**. If it had been a member, we would have prosecuted severely within.

Senator **Kerrey**. Thank you, Mr. Chairman.

The **Chairman**. Thank you.

Senator Cochran.

Senator **Cochran**. Thank you, Mr. Chairman.

Mr. Chairman, this is not unlike a lot of hearings that occur here in the Nation's Capital after publicity surrounds an event of some notoriety. Congress tends to rush in and react to that publicity, sometimes not with the best results.

I was thinking the other day of a report I saw on the subject of the so-called Pentagon procurement scandals. After an awful lot of copy had been written and a lot of news broadcasts, somebody made the observation that those who were being prosecuted were being prosecuted under current law.

I think we should not forget that we do have an abundance of laws on the books right now that seek to address and deal with problems that are being discussed here in this hearing and in the media, as well; and I would hope we could focus on how we can strengthen and rebuild confidence in our futures markets, if that is possible, through legislative action or through regulation.

I know that each of the witnesses here have been asked by the committee to respond to a list of ideas that have been developed in this committee for strengthening regulations and curbing abuses of trading practices, and the like. And there have been forthcoming from some of the exchanges some recommendations, some changes in regulations, some new rules that are being enforced by the exchanges.

I notice, for example, the CFTC has also reviewed these, and in some cases specifically approved them, as steps toward curbing abuses and trying to rebuild confidence in the markets.

I guess my question is, having looked at the proposals advanced by the committee in terms of ideas for action, could each of you give us a response today about changes in legislation that you feel would be constructive acts by the Congress in dealing with the abuses that have been revealed to us?

Could we start with the chairman of the Board of Trade?

Mr. **Mahlmann**. Senator, I believe that the necessary legislation is in place, that the agency that is to monitor the self-regulation of the exchanges is in place. It has all the powers given to it by Congress that I believe it needs to monitor the exchanges.

It has within its powers to change, not approve, and alter our rules. I think the agency is in place with all of the tools that it needs. I do not think it needs any expansion of those tools. They have what they need.

We, as an exchange, have taken 21 different steps, or 19 different steps, of enhancing, strengthening our rules. For instance, we have tripled our fining power for each violation. All of our rule changes are subject to our oversight agency's approval.

So, if there is something that an exchange does propose which does not meet their standard, they can refuse to approve it. But we have taken some 20 steps to improve the integrity. Some of them are rule changes, regulation changes, dramatic enhancements through our computer capability.

I think the regulatory structure is in place to monitor, enforce, and adjudicate any cases within the industry.

Senator **Cochran**. Can we hear from the chairman of the New York Mercantile Exchange, Mr. Guttman?

Mr. **Guttman**. Senator, I would like to follow up on the very similar line, as Mr. Mahlmann from the CBT indicated.

We at NYMEX feel that all the regulatory and the oversight abilities that our industry should be placed under, are already in the hands of the CFTC. I could indicate to you from personal experience that when we do well, they come in and pat us on the back.

And if we kind of stand out of line, they kick us in the shins; and it hurts.

We feel that the existing structure with the CFTC oversight and the self-regulatory responsibilities of the exchanges, and in light of the events of the last 3 months, with the spotlight placed upon us—Senator, we are all prudent businessmen. We know that we have to be responsive to the public interest, responsive to the CFTC, and responsive to this committee.

It is not lost on any of the administrations of any exchanges. And I can assure you that the legislative powers already in place is sufficient, and the New York Mercantile Exchange will commit whatever financial resources and whatever human resources it needs to follow through forcefully and effectively on these responsibilities.

Senator COCHRAN. Mr. Fink, what is your reaction to my question?

Mr. FINK. Thank you, Senator.

You are right, Senator. The futures markets depend on a body of users that has to be large and diverse, and there is no question that that body of users will be neither large nor diverse if one group of participants is able to take systematic advantage of another group of participants.

Many of the rules dealing with misconduct at COMEX were self-generated. Others were definitely pushed along by, as I indicated in my testimony, the prod of the CFTC.

We believe that the existing structure is working well. Our presence here today is indicative, I think, that it is, and therefore we have no specific recommendations regarding legislative proposals.

Senator COCHRAN. Mr. Melamed.

Mr. MELAMED. Senator, thank you.

I do not believe that legislation is needed, nor is that the answer. The legislation is in place. I believe that the standards will have to be met by the industry itself because I believe very strongly, as my testimony indicates, in the self-regulatory process, without which we would lose the freedom to innovate.

And therefore I believe it is up to the industry to show that it deserves self-regulation and meet the standards required by the CFTC.

But as far as legislation is concerned, I do not believe that any new legislation is necessary. What is necessary is for the CFTC to maintain the high degree of demands and standards that it has promulgated.

Of course, one must remember that the CFTC's resources are limited, and certainly they demand more resources from time to time, and those ought to be granted.

Senator COCHRAN. I appreciate hearing your reaction.

I still think that it is important to do everything possible within the exchanges themselves and at the CFTC to restore confidence by investors, by farmers, by those who are interested, and in many ways, depend upon the integrity of the exchanges and the process.

It has been a very important part of our economic system for 100 years. It can continue to be a very important part, I think, but I think we are going to have to restore confidence and we are going to have to work together to see that that is accomplished in the quickest possible time.

Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Cochran.

Senator Boschwitz.

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM MINNESOTA

Senator **Boschwitz**. Thank you, Mr. Chairman.

I would proceed along the line that my colleague from Mississippi has done, and add my expression of confidence in the exchanges. Mr. Chairman, I had an opening statement, and I will read from it and also ask some questions as I go along.

Since last January, when we first learned of the FBI investigation into trading practices at Chicago Board of Trade, and the Chicago Mercantile Exchange, lots of heat, and not a lot of light has been shed on the issues.

It is pretty tempting for politicians to grab the limelight, and we are pretty good at that, and bash the exchanges and traders for real, or imagined excesses.

Billions and billions of dollars are traded. I note that you put up there only the number of contracts. What is the volume? I presume you also register the volume in dollars of the Chicago——

Mr. **Mahlmann**. Senator, I think for our exchange, it would take an average volume figure for a contract of about $60,000 to $70,000.

Senator **Boschwitz**. $60,000 to $70,000—that is up close to a $1 trillion in that case—$800 billion, $900 billion a year.

Mr. **Mahlmann**. I think we are close to $1 trillion.

Mr. **Melamed**. Senator, in the cases of the CME, those contracts are even much higher, and the total volume figures in the trillions, literally the highest of its kind.

Senator **Boschwitz**. And do you have a sense of what—you have 1 million trades a day, every business day occurring, in 1988, roughly—how many trades are we talking about in which there had been some irregularities? It must be a very small fraction of 1 percent, I presume?

Mr. **Melamed**. In terms of the percentage of overall trade, it is a small percentage.

Senator **Boschwitz**. A fraction of a single percent, I presume?

Mr. **Melamed**. I think so.

Senator **Boschwitz**. And what we sometimes forget is that lots of folks are involved in these things. Lots of livelihoods are at stake. As a matter of fact I know a lot of people who are involved in making these kind of transactions, as I have known Mr. Melamed over the years. I have never had any reason to doubt their integrity.

Much of the discussion in earlier hearings has been centered around maintaining the strongest possible incentives for self-policing of the exchanges. My friends and acquaintances who are in this business consider this an overriding incentive. They, more than anyone else, in my judgment, have the strongest incentive and the strongest need to maintain public trust and confidence.

Without it, the exchanges will cease to function and their livelihoods, will be jeopardized.

As I say, I have personally known Mr. Melamed over the years and have implicit trust in him. As I also said earlier, I have known many people who have dealt in these exchanges.

I was also quite taken by the additional views in the CBOT recommendation of Senator Eagleton. You, Mr. Chairman, and I knew Senator Eagleton well during his term here. I believe he is on your committee, is he not, Mr. Melamed?

Mr. **Melamed**. Yes, he was on the Review Committee.

Senator **Boschwitz**. Senator Eagleton talked about the reviews and recommendations marking the milestone in the evolution of commodity futures self-regulation. I really urge you on in that regard.

Senator Kerrey talked about $12 million in uncollected fines. Do you have any sense of how much was collected over this period? And that is by the Department of Justice, apparently.

Mr. **Melamed**. As a matter of fact, I have a statistic that fines imposed for the CME, at least, since January of 1987, total something like close to $3.5 million, which predominantly was collected.

I think the Senator's statistics were predominantly about off-exchange fine levies; that when the Justice Department speaks about them not being collected, I cannot speak for the other exchanges, but let me say that at the CME, our procedure is that when a fine is levied against a member, his membership is immediately attached. Each CME and IMM membership is worth around the half million dollar mark. And unless the fine exceeds that value, that fine is paid. So in the case of the CME, very few fines go uncollected.

Senator **Boschwitz**. I gather from the discussion that the Department of Justice of the Federal Government asserts fines and that you do yourself. I presume that you do not have much trouble collecting them unless the people simply decide not to trade with you anymore.

Mr. **Melamed**. They leave a very large asset with us in custody. Those fines are collected.

Senator **Boschwitz**. What kind of fine is the Senator from Nebraska talking about that has gone uncollected? I do not understand the terminology used.

Mr. **Melamed**. Well, I do not know. I cannot respond to that.

Senator **Boschwitz**. I do not understand the terminology used.

Mr. **Melamed**. I do not know. I cannot respond to that.

Senator **Boschwitz**. He referred to student loans. You would be in big trouble if your situation was as bad and as mixed and as murky as the student loan situation. I would trust that that has not occurred.

I see the Senator is back. I asked what kind of fines you were talking about, Senator Kerrey, about the $12 million. What I gather from the testimony is that the exchanges impose some fines by themselves which I presume they collect. I presume in order to be a member you have to put up some money so that you have something to assess in the event that there are some fines?

Mr. **Melamed**. Senator Boschwitz, I was responding that in the case of the CME, the asset is the membership, which often is in far excess of the fines levied. The membership is attached to the fine so that ultimately you have that asset to collect from.

Mr. **Mahlmann**. Senator, the Board of Trade imposes the same practice.

Senator **Boschwitz**. There is a civil monetary penalty. Is that the result of lawsuits.

Senator **Kerrey**. This is the Department of Justice's record of fines, levies, and fines collected.

Senator **Boschwitz**. Against whom?

Senator **Kerrey**. Against individuals who have been judged to have violated trading practices in the exchanges.

Senator **Boschwitz**. In other words, the CFTC also imposes fines upon your members, and it is those fines that have gone uncollected?

Mr. **Melamed**. The CME is going to respond to the inquiry, Senator Kerrey. I suspect those are predominantly, nonmember fines the CME levies, controls, and collects member fines. As I pointed out, we have a very large asset, and the Board of Trade, I believe, has a similar procedure; so that if you are dealing with a $500,000 asset, which is in fact easily convertible to cash, you are going to collect the fine unless the fine exceeds $500,000.

Senator **Boschwitz**. In the event that CFTC imposes a monetary penalty, does your exchange or do the other exchanges assist the CFTC in collecting such fines and penalties? And in the event that the CFTC imposes a fine and the fine is not paid, can the member continue to trade on your exchange?

Mr. **Melamed**. I do not believe we assist them in collecting the fine. I think that if they deny the member privilege on the exchange, then we also deny them the same privilege.

Senator **Boschwitz**. So that the CFTC can deny one of your members the ability to trade on your exchange?

Mr. **Melamed**. That is correct.

Senator **Boschwitz**. Does the Chicago Board of Trade assist the CFTC in the collection of fines that are imposed upon your members?

Mr. **Mahlmann**. We do not assist the CFTC in the collecting of the fine that the CFTC may have imposed, but as in the Mercantile Exchange, the CFTC has the right to stop a member from doing any trade on the trading floor or working on the trading floor, thereby putting them out of business.

Senator **Boschwitz**. Does Mr. Guttman——

Mr. **Mahlmann**. If we were asked, we would assist the CFTC, but it had never occurred yet.

Senator **Boschwitz**. The CFTC does not ask you?

Mr. **Mahlmann**. I guess not.

Mr. **Guttman**. We have a very similar arrangement, Senator. Our seats are valued at approximately $350,000 and stand behind the collection of any and all fines. Virtually all fines imposed by the disciplinary committees on the exchanges are paid.

In the event that the CFTC imposes a civil fine against an individual, if the CFTC would, and I am just suggesting, get the court order for us to freeze this individual's assets, we would respond to the court order. To date, the CFTC has never approached us as an exchange asking that the exchange act in the collection capacity for a civil fine imposed on a particular trader.

But again, on our exchange, if we get an order from the CFTC banning any individual member from our exchange, then within minutes, he is gone.

Senator **Boschwitz**. In the event that somebody does not pay a fine to the CFTC, does the CFTC normally approach you and say you should ban this fellow from trading?

Mr. **Guttman**. I am told by counsel, Senator, that we have never in the past been asked to ban a member for failure to pay a fine issued by the CFTC.

Mr. **Melamed**. Of course, the CFTC has access to the courts, and if a judgment is rendered by virtue of any of these things, of course, then the asset becomes subject to that judgment. But outside of that process, I do not recall any involvement with the collection of fines by virtue of a CFTC sanction.

Senator **Boschwitz**. Well, I share with Senator Cochran's view that your exchanges are of great value to my constituency and to the Nation as a whole; and I really do urge you on to self-regulate in such a way that we do not have to further legislate.

I think that if we further legislate and establish new rules and regulations that we probably will impede the process of these exchanges, and that would not serve the national interest.

My viewpoint would be to look for very strict self-regulation; and I am pleased that you, Mr. Melamed, have proceeded in that fashion in your exchange, and I trust that the other gentlemen have as well and will continue to do so. I will be supportive of those kind of efforts and also supportive of efforts not to impede transactions in the normal conduct of business.

Thank you, Mr. Chairman.

[See the contents for the prepared statement of Senator Boschwitz.]

The **Chairman**. Thank you, Senator Boschwitz.

Incidentally, Senator Lugar has been tied up at the markup of the Committee on Foreign Relations. In fact, every single Senator on this committee has had at least two or three conflicts a day. I would ask unanimous consent to put in the hearing record the prepared statement by Senator Lugar in the record immediately after my own opening statement.

I have some more questions. But, first, Senator Kerrey, you said you had a followup question you wanted to ask.

Senator **Kerrey**. Thank you, Mr. Chairman.

Mr. Mahlmann, I am trying to understand the procedure that is followed in cases of fraud. When I asked you earlier about the *Sanders* case, why you went to the U.S. Attorney, the indication was that the reason you went to the U.S. Attorney instead of going to the CFTC was that the perpetrator was outside of your jurisdiction. Is that——

Mr. **Mahlmann**. We have jurisdiction over our members, over our member firms, and their employees.

Senator **Kerrey**. Sanders was not a member of the Board of Trade at the time?

Mr. **Mahlmann**. Sanders was not a member of the Board, nor were his accomplices members of the Board or employees of the

Board or of any member firm of the Board at the time that this was perpetrated.

Senator **Kerrey**. I am confused by that. How was he expelled and how did you end up fining him later if he was not a member of the Board?

Mr. **Mahlmann**. We went retroactive. He had sold his membership, and we retroactively assessed him a fine. [Pause.]

My general counsel just clarified something.

Tom Sanders was a member at the time the trades took place in 1986. The cohorts that he had were nonmembers, were not employees of a member firm that he used to put the trades into various accounts, through disguises and access on the floor, were nonmembers, therefore outside of our jurisdiction.

Senator **Kerrey**. He was not outside your jurisdiction?

Mr. **Mahlmann**. He was not.

Senator **Kerrey**. He was the ring leader. He is the one doing time. He is the one that got a $1 million fine——

Mr. **Mahlmann**. We did not have in our investigative process—and by then we are going back to 1986—our CTR surveillance system was developed since 1986. We did not have the computerized trade capability, a surveillance capability, at that time.

We were unable to determine that he was the ring leader. We did suspect outsiders, and therefore we went and we suspected fraud; and therefore we went to the U.S. Attorney's office and not to the CFTC.

Senator **Kerrey**. You are saying that the rule is or the guideline is that you go to the U.S. Attorney if its a nonmember, and you would go to the CFTC if it was a member, and yet the ring leader—I see your head shake——

Mr. **Mahlmann**. No, it is not.

Senator **Kerrey**. No?

Mr. **Mahlmann**. It is not.

Senator **Kerrey**. That is not the guideline?

Mr. **Mahlmann**. We were unable to ascertain it was Tom Sanders. We did not have the evidence that it was that man that did the perpetrating of the crime.

The perpetration of the crime was, at his instructions and mastermind, done by nonmembers at the particular time. There was a man named Pallou, and Dan Dewey, who had been a member quite a number of years ago, but was a nonmember. Those are the people that showed up in disguise on the exchange floor. They perpetrated the crime. They used the member Tom Sanders account to clear the trade, but he was not the one that actually gained access to the floor.

We suspected that it was a nonmember, and we suspected it was fraud. We suspected it was criminal activity. No, we did not have the evidence. We were stopped in getting to the ultimate point. Therefore, we turned it over to the U.S. Attorney.

Senator **Kerrey**. So you are saying that the guideline is still there, in other words?

Mr. **Mahlmann**. We have jurisdiction over our members, over our member firm employees, over our member firms.

Senator KERREY. And had you suspected that this was a member, then you would have gone to the CFTC rather than U.S. Attorneys?

Mr. MAHLMANN. No, we would have done it ourselves.

If we know it is a member and can prove that it is a member or an employee of a member firm or the member firm itself, we go after them full-blast.

Senator KERREY. Well, I do not want to give you the impression that I am persuaded. I am still concerned about the lack of a mechanism that enables you to accomplish the self-regulation as the Senator from Minnesota referenced for me. I, as well, want to maintain as much self-regulation as possible.

I am less concerned about an evaluation of the rules and trying to figure out what changes we need to make than I am about making certain that along with whatever rules we have, we have a mechanism in place to identify those who have broken the rules, a mechanism in place to prosecute, a mechanism in place to impose the fine and a mechanism in place to collect the fine.

It would seem to me that at least, on the last score, we do not have the mechanism.

Mr. MAHLMANN. What do you mean in the last score, Senator?

Senator KERREY. The collection of the fine. The CFTC does not have an effective mechanism to collect the fine. We have already heard that they do not even notify you and ask you to assist in the collection of the fine.

Mr. MAHLMANN. Senator, I think we are collecting almost all of our fines that we, as an exchange, have ever meted out. We will, at your request collect the data and present it to you.

[See page 222 for CBOT Fine Collection History.]

Senator KERREY. How much of the Sanders fine have you collected?

Mr. MAHLMANN. Sanders is in appeal right now against our decision.

Senator KERREY. All right.

The CHAIRMAN. Senator Boschwitz.

Senator BOSCHWITZ. When you submit the data on these fines, would you also submit the general reasons that the fines were imposed by the CFTC, just for the sake of my information?

Mr. MAHLMANN. Would you ask the CFTC to explain to you what fines they impose?

Senator BOSCHWITZ. Okay, we will ask the CFTC to do that. I presume that you will proceed with that, Senator?

Senator KERREY. Yes.

[The material was subsequently provided for the record.]

During fiscal years 1987, 1988, and the first half of 1989, Commission administrative enforcement actions resulted in the imposition of nearly $5,000,000 in civil monetary penalties. This amount does not include several penalties assessed by the Commission on Administrative Law Judges but later reversed on appeal. The penalties imposed by type of case were:

Trade practice	$1,003,900
FCM fraud	986,500
CPO/CTA fraud	735,000
AP fraud	414,000
Off-exchange fraud	145,000
Options fraud	31,000

Introducing broker fraud	309,500
Failure to register	50,500
Recordkeeping and reporting	112,500
Speculative limits	175,000
Financial requirements	930,500
Other	15,000

Additional monetary penalties have been imposed during the second half of fiscal year 1989, but in some cases remain subject to potential appeal.

Senator BOSCHWITZ. The Senator from Nebraska was most direct when he said that the word has gone out to crooks and that thieves will go largely unpunished. I wonder if you would respond to that allegation.

Mr. MAHLMANN. Senator, I passed a sheet out before. I do not know whether you were here at the time. The Board of Trade last year started 1,464 trade practice inquiries which resulted in 53 guilty findings, which resulted in $1,450,000 worth of fines, and which resulted in 17 years suspension and 1 lifelong expulsion.

When we sanction an individual and suspend and/or expel him, we not only expel him from our exchange, but we put the additional sanction on that he cannot work for any member firm of the Chicago Board of Trade in any capacity. And seeing that we are the largest exchange in the world, that means he can basically not work for any member firm or in this industry on any exchange.

Senator BOSCHWITZ. Well, the 53 guilty findings involved how many trades?

Mr. MAHLMANN. How many trades?

Senator BOSCHWITZ. Yes.

Mr. MAHLMANN. I cannot give you that data at that time.

Senator BOSCHWITZ. So you do not feel that the word has gone out that the people who misbehave will be only mildly treated?

Mr. MAHLMANN. All I can speak for is the Chicago Board of Trade. Our members, knowing that the radar gun that is above them has generated—out of those 1,400 cases, almost 1,000 of them—are extremely concerned that they could be caught, that they could be falsely accused. They do not want to be caught. They are committed to preserving the rules and abiding by the rules. Yes, we found 53 of them and we dealt harshly with them.

Senator BOSCHWITZ. Mr. Guttman, do you think the word has gone out that people who do not abide by the rules of your exchange, you are going to be lightly treated?

Mr. GUTTMAN. Senator, not only has the opposite word gone out, but I sent out the word personally this past week. On Wednesday, I called for general membership meeting, not only just to review the Regulatory Review Task Force recommendations, but to give them an overview of the events in Chicago and New York; and it was made perfectly clear to members of our exchange that the New York Mercantile Exchange will enforce its rules and regulations and enforce them severely, and the punishment will be commensurate with the crime. The future, as will be demonstrated, is not going to be consistent with the perceived situation of the past.

That has been made perfectly clear to our membership, and as I indicated to you, I did that myself along with the Board of Directors of our exchange.

Senator **Boschwitz**. Has it been the perception in the past that violations of your rules will not be harshly prosecuted?

Mr. **Guttman**. No, sir. What I meant by that statement is that the pace of which they might have perceived the rules to be enforced; that the emphasis and the severity of the fines are going to be increased way beyond what they have experienced in the past, sir.

Senator **Boschwitz**. Mr. Fink, would you comment? What commodity exchange and what kind of contracts do you trade as a matter of interest?

Mr. **Fink**. Gold, silver, copper, and aluminum.

Thank you, Senator. I think, as I indicated earlier, COMEX has had a long standing commitment to dealing with misconduct among its members, as the data suggests, in terms of the size, the number of fines, the number of suspensions. Our commitment is significant, perhaps, depending on how the data is massaged, the largest and most severe in the industry.

I believe that message has very definitely gotten to our members, and if it has not gotten to the world at-large, then I think we are doing a poor job.

Senator **Boschwitz**. Mr. Melamed, would you also comment?

Mr. **Melamed**. I would be glad to, Senator.

The Chicago Mercantile Exchange is and has been committed to a policy of strong enforcement of any rule violation, and I will let the record speak for itself. The GAO disciplinary action chart that is here, I think, is very indicative of our record in terms of what it shows for the last several years, including the number of members that have been sanctioned as well as the level of fines.

I think you will find that our record compares with any futures exchange as well as with any securities exchange. We are committed to a strong enforcement policy. We deal very, very harshly with anyone who is found guilty of any violation of our rules, and we will continue to do so.

Senator **Boschwitz**. I think it is important that you do so.

Why, Mr. Melamed, did it bounce up and down like that on the chart—the suspensions—from the standpoint of days, and even the standpoint of a monetary fine?

Mr. **Melamed**. Well, it depends on what type of case is brought to a final completion at a given moment in time. Sometimes, when you have a very involved and aggravating case, the fine is so substantial that it will skew that particular year differently than others; so that it is very hard to identify that.

The Board of Trade instance is an odd, peculiar one that I do not think you would run across in another hundred years, maybe—a similar kind of situation. So you really cannot make that kind of judgment.

What you have to look over is the effect of time. What is happening in terms of our fine schedule, and it is unmistakably moving higher. We have enforced our rules with a strong arm, and even to a harsh degree as the record indicates.

Senator **Boschwitz**. The confidence of a lot of people rides on what you do in these matters, so I urge you on so that the Senator from Nebraska and others will not feel that those who commit various irregularities do not get the most severe punishment meted out to them. That is certainly the way it should be, particularly in view of the fact of the importance of your exchanges to the conduct of business and commercial trade in the United States and the world. The reliance on your exchanges is of extraordinary importance.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I have a few wrap-up questions. Some others will be put in the record. I just want to make sure I understand a couple of items here.

With the Chicago Board of Trade, I am still confused on the numbers. I understand that, with some of the other exchanges, the numbers that we have been given by the Commodities Futures Trading Commission are off a little bit. But they seem to be off a great deal with the Board of Trade. Mr. Melamed, I have been looking at the addendum to your testimony.

In 1987, you show in your addendum $125,000 in fines based in trade practice violations, which would be considerably less than what the CFTC shows—about $65,000 less than what the CFTC shows. But then, in 1988, you show $1,450,250 in their fines, which is about five times or so larger than what the CFTC shows.

Just using your numbers, which of these would be the normal level? What would you normally expect to see in a year? Would it be the $125,000 or the $1.4 million?

Mr. MAHLMANN. Senator, it varies by the crime that is perpetrated. We deal with our members severely when there is a crime. I do not think you can predict a crime rate of what it should normally be. I hope it would be zero.

The CHAIRMAN. Why was there that huge jump between 1987 and 1988?

Mr. MAHLMANN. I do not know. I cannot, at this time, recall each fine, but there is a commitment to the severity of penalty. There have been or might have been an extremely egregious situation. I cannot make any comment this early in the jump at this time.

The CHAIRMAN. Well, I want to ask the committee's——

Mr. MAHLMANN. Mr. Chairman, I would like to offer, and I understand that there is a dialog between the CFTC and the various exchanges, in order to bring these figures all on a common denominator between accrual and cash basis accounting, so that this committee has a solid foundation.

If you were to let a committee staff member work with this group to bring all parties on a common denominator——

The CHAIRMAN. Obviously, we are going to have to. That is what I started to say. We will have the committee staff work with your office and with the CFTC. I do not want to make a distraction of the numbers, but as one aspect of what we are looking at, we at least want to be working from the same data base. I suspect each one of you would want us to be doing that, too.

Was the *Sanders* case—the fine in that case was over $1 million alone, was it not?

Mr. MAHLMANN. That occurred in 1989.

The CHAIRMAN. That still would not be in these numbers. On April 19, the Chicago Merc published a series of proposals to improve regulation on the Merc's floor. In an addendum to that report, Senator Tom Eagleton, a well-respected and knowledgeable former Member of the U.S. Senate, and a member of the CME committee, argued that the CME proposals really applied to all exchanges and that the CFTC should impose them industry-wide.

I would like to ask you, excepting Mr. Melamed for the moment, about some of these proposals. We have discussed dual trading separately, so we can skip that here. Let us see whether their ideas should be industry-wide.

First, should exchange rules require the presence of nonmembers with voting privileges on each exchange disciplinary committee with at least one nonmember present on each committee hearing a disciplinary case?

Mr. Mahlmann, how does that sound to you?

Mr. MAHLMANN. Mr. Chairman, I would go back to the letter and the quote I inserted in my oral testimony from Mr. Anton Valukas, at the Kent Law Institute in Chicago, where he said that the members of the Board of Trade are the best adjudicators of the trade practice violations that——

The CHAIRMAN. So you would not be in favor of the exchanges being required to appoint nonmembers with voting privileges to each exchange disciplinary committee with at least one nonmember present on each committee panel hearing a disciplinary case?

Mr. MAHLMANN. It is my strong feeling that the members are the best adjudicators. I feel the same way.

The CHAIRMAN. So then you disagree with that recommendation?

Mr. MAHLMANN. Yes, I do.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Mr. Chairman, I would like to point out that one of the recommendations of our Regulatory Review Task Force was that on disciplinary manners, that outside individuals be invited into the disciplinary functions of our committees; and that the committee structure as we have had in the past be more beefed-up that we now will have full standing committees throughout the year rather than having these committees meet on a three, four panel basis.

And we would welcome outside, nonmember participation in the proceedings of our disciplinary committees.

The CHAIRMAN. Thank you.

And, Mr. Fink, how about the COMEX?

Mr. FINK. Thank you, Mr. Chairman.

As the Board of Trade does, we believe that the members are the best adjudicators available. A structure that we believe works well is the one that we have used at the exchange for many years in which there is substantial representation from the outside nonfloor members, the users, the customers of our markets whose orders are in jeopardy by misconduct.

It is our feeling that the use of outsiders may dilute the ability of the committees to deal effectively with trade practice abuses, and we continue to stick to the idea that as long as we have representation from people in the upstairs community, that we are doing fine.

The CHAIRMAN. The NYMEX and the Merc are very much in agreement on this proposal, then, while the Board of Trade and

COMEX take the opposite view. I am not debating anything. I just want to make sure we understand your positions.

Mr. **Mahlmann**. Mr. Chairman, if I could?

The **Chairman**. Sure.

Mr. **Mahlmann**. For the record, I would like to clarify one other item.

The ultimate disciplinary committee of the Chicago Board of Trade is the Board of Directors. That Board is made up of a substantial number of commission house representatives and clearing firm representatives, all floor representatives, inclusive of outside public directors, so on that committee as the ultimate adjudicator, you have a substantial outside representation.

The **Chairman**. But that is like the ultimate trial jury. There are intermediate steps where determinations are made whether to go forward with a case or not, such as whether to bring a true bill. At that point, there are no outside members.

In other words, a decision can be made not to go forward with a proceeding, not to pursue a particular disciplinary complaint, with no outside members present. Is that correct?

Mr. **Mahlmann**. That is correct.

The **Chairman**. Thank you.

A recommendation was made that all exchange members be required to register with NFA as floor brokers so that they would be subject to FBI fingerprint checks. I believe the CFTC has proposed legislation requiring this.

Mr. Mahlmann, how do you feel about that?

Mr. **Mahlmann**. I think at this time, as an exchange, if we required our members to register, we would not be able to get the FBI fingerprint check available to us or the results, thereof. Is that correct? I have to ask my general counsel.

The **Chairman**. So do you agree or disagree that all exchange members be required to register with NFA as floor brokers?

Mr. **Mahlmann**. Our members are registered, in effect, with the CFTC by being members of the exchange. So they are registered already.

The **Chairman**. Would you be in favor of legislation to require this?

Mr. **Mahlmann**. I think the CFTC has the authority.

The **Chairman**. Mr. Guttman.

Mr. **Guttman**. Mr. Chairman, I would like to indicate that our membership committee, before accepting a member for membership, does an in-depth background check into the person's financial, criminal, and/or civil history. These are background checks that are made available to us.

Any further registration, of course, would only enhance and cover certain areas that might not have been available. We are not opposed. In fact, we are in favor of these registrations with the NFA and their fingerprinting procedures. We do not have access to FBI fingerprinting procedures, and if the NFA does, we will more than happy to submit our membership to these registration proceedings.

The **Chairman**. Thank you.

Mr. **Fink**. Mr. Chairman, our advisory panel has not formulated an opinion on this subject. My initial reaction is the question of whether measures of this kind are going to be truly cost effective. We have nothing against the notion of widespread registration in the industry as long as it produces significant results for the amount of money that is being spent.

The CHAIRMAN. Thank you.

Another proposal was that the exchanges adopt penalty guidelines requiring that any member with a second major rule violation or a fourth minor violation be expelled from the exchange.

How do you feel about that, Mr. Mahlmann?

Mr. MAHLMANN. Just also for everybody's benefit again, these are proposals. They are not implemented items, and as Mr. Melamed explained, these items are going through a review process.

Yet, the Board of Trade's strong feeling seems that not every exchange is identical. Each one has a different trading market, different trade practices, different heritage. We feel strongly that each exchange should be permitted to develop, by a mandate of an objective, develop its own path to achieving that objective.

We, as a Board of Trade, did implement a number of these steps ourselves. We have 20-some that we added in our supplement and in our written submission.

Out of all of those steps is a single one which the membership has yet to vote on, which addresses this point, which is an increase of the fining power per incidence on our exchange from $75,000 to $250,000. It is over a 300 percent increase.

That is the only item out of the Board of Trade package which has yet to go to the membership for approval. All other steps in the Board of Trade package are done deals.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Mr. Chairman, our Task Force has reviewed that item, and the Task Force's recommendation was, one, when any member is being fined $25,000 or suspended, it should, of course, be publicized.

In regard to establishing preset fines for any preset violation and what actions to be taken thereafter, Mr. Chairman, we sincerely believe that that decision should be left up to the exchanges.

It is possible that the committee and, of course, the outside directors or the outside participants of the committee which I alluded to earlier, might wish to impose a higher fine for a particular violation; and if we preset or predetermine what these fines might be, it might limit or hamper that committee's ability to impose higher fines.

So therefore, we feel that these fines and the terms of the penalties and how many violations for expulsions should be best left to the disciplinary committees of the exchanges with the assurance, as I indicated, that we will do everything in our power to make sure that these fines are and will be commensurate with the violation.

The CHAIRMAN. Thank you.

Mr. Fink.

Mr. FINK. Mr. Chairman, the exchange, COMEX, believes that the best judge of what fine should be leveled is the exchange itself, what fines should be leveled against what offenses. It also should be the main, if not the sole judge, of what threshold of repetition would justify expulsion.

The CHAIRMAN. What about banning verbal orders between members on the floor? How about that, Mr. Mahlmann?

Mr. MAHLMANN. Senator, the liquidity transfer that occurs, for instance, from an underlying futures pit to the options pit requires the order from one pit to the other to be flashed or given in a verbal form.

If we eliminated that facet of our trade practice on our trading floor, we would dramatically diminish the value of either instrument, both the underlying as well as the option of the underlying. So we have to carefully address what diminution we want to give to verbal orders. We are addressing the issue, yet, at the Board of Trade, but we have to be very, very concerned that we do not affect the liquidity.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Mr. Chairman, if I might just read the five lines to you from our Task Force report addressing just this issue, it says, regarding oral orders, that the Task Force recommends that the Board adopt rules banning oral orders between members, for a member's account with limited exceptions for intermarket spreads and options offsets.

In essence, what we are saying or suggesting, Mr. Chairman, is that when two members are standing in one pit trading the same identical commodity, that oral orders be banned. But in the event that this particular commodity has to be offset with a futures transactions in another pit, that under those conditions oral orders be acceptable.

The CHAIRMAN. Thank you.

Mr. Fink.

Mr. FINK. This issue, Mr. Chairman, is still under review at the exchange. Verbal orders cannot be uniformly banned on the basis of the arguments that were presented by the chairman of the board of the Chicago Board of Trade.

Perhaps, however, some attention should be given to the issue of providing order tickets for every oral or verbal order that exists so that there is some effort to provide a document trail.

The CHAIRMAN. How about requiring that broker associations register with the exchange and banning their members from trading their personal accounts against orders executed by other members of the same group.

How would you feel about that, Mr. Mahlmann?

Mr. MAHLMANN. Mr. Chairman, basically the Board of Trade does not really have broker groups. It does not seem to be our problem. It seems to be more, maybe, on the Mercantile Exchange.

We will require, however, anybody that works as brokers together that they register with the exchange. That has been passed and is implemented.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Well, again, Mr. Chairman, if I may just briefly read to you the Task Force's recommendation. These are the affiliations between floor brokers:

"The Task Force recommends that the Board adopt rules requiring floor brokers to register their affiliations, if any, to enable the Compliance Department to better monitor trading between affiliated floor brokers.

"The Task Force also recommends the development of a new customer-type indicator for trades executed on the floor by one broker for the customer of another broker."

Mr. Chairman, we do not have formal broker affiliations. We have what we call certain "member firms" which are registered with the exchange. But we do have on the floor a limited number of brokers that do assist each other in one's absence. In essence, they are pinch-hitters for a certain period of time.

In fact, what we are recommending is that even those pinch-hitters at those particular instances be registered with the exchange, and that when one of these pinch-hitters do execute an order for someone else's customer that we create a new trade identifier, which we call 5-C, where the Compliance Department could track, on an audit trail basis, that this 5-C transaction was on behalf of a customer of another broker.

So it will give us a greater and enhanced audit trail to follow-up on.

The CHAIRMAN. And Mr. Fink.

Mr. FINK. Mr. Chairman, the registration of broker associations and broker affiliations is an important element in preventing abuse. That is why COMEX put this rule into place at our exchange a long time ago.

CLOSING REMARKS

The CHAIRMAN. I have a number of other questions for the record. Each of you may find later on some further points you want to add. We have gone into some fairly technical areas. When you look at the testimony if you find something you wish you had thought of before, please feel free to add it. After all, the main reason for this hearing is to get the expertise of the four major trading organizations.

I said I had a list of ideas which I have circulated for comment, some of which I like and some of which I do not particularly like. One of these concerned the exchange governing boards. Each exchange has a board with public members, and some of you may even actively recruit for the position. One proposal from my list which received fairly wide support from those who commented on it was to require greater representation of exchange governing boards of such non-floor interests as wire houses, trade firms, and public members.

Wally Fisher, from a major farm organization, wrote that they strongly agree with this proposal. You may want to send me some of your thinking on how you set up your boards and what you do in the way of recruiting. I think this is for your own sake; it certainly helps public confidence. It is not a bad thing to do.

Now that we have completed three major hearings on trading practices in the futures markets, let me give you an idea of where I think we stand on the reauthorization of the CFTC and possible futures legislation this year—should anyone be interested.

It would be difficult to proceed with a full-term CFTC reauthorization of 3 or more years if we do not learn more about the findings of the Chicago and New York probes. I have talked with the Attorney General about this. Obviously, we need to be sure that we are addressing the right problems. You have heard some of the feelings around this table. A lot of other Senators have talked to me privately. Some want to make sure that we do not throw the baby out with the bathwater; others are concerned that we are not taking necessary steps. Congress and the public remain skeptical about the performance of the exchanges in policing their floors against trading abuse.

This skepticism, and the publicity of the recent probes, while I am sure that none of you liked it, has had a salutary effect. Futures exchanges today—all of you—are doing a lot of soul-searching, and I commend you for that. In fact, the reports and proposals to upgrade self-regulation that I have seen are very encouraging to me as one member of this committee.

Meanwhile, I see consensus forming around certain regulatory improvements which should be made regardless of what the Chicago and New York probes eventually find.

We have received some proposals made by the CFTC in response to my list of suggestions from March 9, though I am a little bit disappointed that so many of the items are still under study, and I was not quite sure of the position they took on a couple of items; they were a tad mushy in their response.

Some of the ideas contained in reports by individual exchanges, particularly that of the Chicago Merc special committee, which appear to have industry-wide applicability. Some of you disagree on these, as you have stated in your testimony here today.

There seem to be a few things we should have. One is funding authorization levels for the CFTC which realistically reflect the potential staffing needs of that agency. I do not think these have been realistic in the past.

On dual trading, the futures industry appears divided. If the GAO or the Chicago and New York probes demonstrate that dual trading in fact is connected with substantial abuses, however, I think we are all realistic enough to know that limitations will be inevitable. We will continue to explore these questions in hearings over the next several months.

I thank the futures industry, the CFTC, the market user community, and the public for the constructive input we have received from you in this process so far. Your contribution to our work has been substantial.

I want to add for the sake of the press and others that we have had a great deal of cooperation from the exchanges in the questions that I, the staff, and other committee members on both sides of the aisle have asked. They have given us quick responses. There is no question in my mind, as an individual Senator, that the heads of the various exchanges, the Board members, the presidents of the exchanges, the directors and other officials are very concerned about potential trading abuses. They have taken this issue seriously. Each of you has a great deal of expertise and you are going to bring that expertise to bear.

There is also no question in my mind that there are thousands of people working in these exchanges who understand the rules and have every intention of abiding by the rules and will abide by the rules.

There is also no question in my mind that it is absolutely necessary for this country for a number of economic, social, and commercial reasons that these markets be able to work and work well. With fast changes in communications, commerce, technology and everything else, you must have the ability to be technologically advanced and to use innovation. This is what allows the United States to be a major factor in the kinds of trading represented by your exchanges. We do not want to limit that innovation.

I think we would all agree that these markets work only so long as they are credible so that the average person can feel confident in the integrity of the markets and the people surrounding them. A lot of the future trading process is done on faith. The average person cannot walk into these markets and make heads nor tails out of what appears chaos if they are not used to them.

We all know the importance of futures markets. I would urge that we all work together to maintain them. We must guarantee the public their integrity. If some people break the rules or take advantage of what they see as a loophole, we must work together to get rid of those people.

I think you are all united in this. You may disagree over particular rules, but I think you all agree that if you have people who break the rules and bring disgrace or destroy the credibility of your markets, you want to get rid of them. You have no need for them. There are enough other good people to take their places.

And lastly, we must keep the ability to be innovative. If we are not, other countries out there are going to step in and be just as innovative.

I appreciate your being here. There will be further questions for the record from different members. I know you have spent a lot of time here and I suspect that you much prefer Chicago or New York to Washington at this time of year. But thank you. We stand in recess.

[Whereupon, at 12:35 p.m., the committee adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF LEO MELAMED, CHAIRMAN OF THE EXECUTIVE COMMITTEE, CHICAGO MERCANTILE EXCHANGE

My name is Leo Melamed. I am Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME). Also representing our Exchange today are John T. Geldermann, Chairman of our Board of Governors, John F. Sandner, Senior Policy Adviser to our Board, and William J. Brodsky, our President.

When we were last before this Committee, we presented detailed and extensive testimony respecting the 1987 stock market crash and the valuable role played by futures markets acting as a safety valve to absorb selling pressure. This Committee refused to be swayed by uninformed calls to blame futures markets for the crash. You listened fairly and fully. Your faith in our markets was rewarded. The eventual evidence proved not only that futures markets had performed flawlessly during the crash, but confirmed their indispensible role as a risk management mechanism for finance and agriculture. Moreover, we were good to our word and made the kinds of improvements that you thought might be advisable.

Mr. Chairman and members of the Committee, we appreciate your continued interest in the long-term viability of our industry. We value this opportunity to appear before you and respond to your inquiry about our market's surveillance systems. I must say at the outset that your faith in our ability to self-regulate is not misplaced. The picture we will present is in stark and stunning contrast to the sensationalized accounts you may have encountered during the initial stage of the announced federal investigation of our markets. Not only are the issues defined by your invitation the very problems that have focused our attentions for the past three years, but in a continuing quest to insure the integrity of our markets, we have openly demonstrated a willingness to conduct a thorough self-examination of all our trading practices.

As the record of past events makes clear, the CME determined that in addition to its ongoing rule reviews, it should take full advantage of the atmosphere and publicity created by the announcement of the federal investigation of futures markets. At a Special Meeting on Wednesday, January 25, 1989, the Board of Governors of the Chicago Mercantile Exchange voted unanimously to respond constructively to the resulting cloud about our ability to self-regulate and undertake a comprehensive internal review of all CME trading rules and practices. Toward this end, the Board directed the formation of a Special Committee.

The Special Committee to Review Trading Practices was comprised of five public and industry representatives -- some of whom are CME public and industry governors -- and four officials of the CME. It was chaired by John T. Geldermann, chairman of the CME Board of Governors, and Co-Vice Chaired by Dr. Susan M. Phillips, former chairman of the Commodity Futures Trading Commission (CFTC), and Leo Melamed, Chairman of the CME Executive Committee. Other public and industry members of the panel included former Senator Thomas F. Eagleton of Missouri; Donald Butler, former president of the National Cattlemen's Association; Louis I. Margolis, Managing Director of Salomon Brothers, Inc.; and John A. Wing, President and Chief Executive Officer of The Chicago Corporation. The other CME officers on the Committee were John F. Sandner, immediate past Chairman of the Board, and William

J. Brodsky, President and Chief Executive Officer of the CME. Robert K. Wilmouth, President and Chief Executive Officer of the National Futures Association, served as Special Advisor to the Committee.

The Special Committee was charged and empowered to conduct a comprehensive study of the entire structure of CME trading rules and practices, surveillance systems and enforcement standards in order to formulate recommendations for change. The Special Committee was given full latitude in this process and had the unrestricted assistance of the CME administration. In the course of its examination it held numerous meetings, three of which were conducted to receive testimony and question more than forty expert witnesses. Those witnesses included representatives from the FCM (Futures Commission Merchant) community, the legal community, a diverse group of users, academics, and CME floor brokers and traders.

Expert witnesses were encouraged to testify on any trade practice-related topic and expressly requested to provide input on specific issues; e.g., dual trading, broker associations, customer pressure for guaranteed prices, market openings and closes, fast markets, electronic surveillance, as well as disciplinary matters, including committee composition and minimum sentencing guidelines. The Committee also received extensive written testimony from other experts within and outside the industry. In addition, the Committee studied the last three rule enforcement reviews conducted by the Commodity Futures Trading Commission (CFTC) covering various periods from 1985 to 1988 and the CME's responses to those reviews.

The result of this far-reaching effort is a set of comprehensive recommendations for review and implementation by the Board. The substance of some those recommendations will be fully discussed below.

It must, however, be underscored that the Special Committee recognized that its recommendations were broad and of a nature that will result in major structural changes. Accordingly, the Committee acknowledged that its recommendations will require careful analysis by the Chicago Mercantile Exchange Board of Governors and its membership. Moreover, its recommendations will also require refinement and fine-tuning as well as the adoption of a policy for implementation that will result in a minimum of disruption to the markets.

That process is currently underway. The Board of Governors of the CME has appointed six special committees to review each of the major categories found in the recommendations. It will be the objective of these committees to examine the recommendations in the context of practical application, as well as to fine-tune, modify or suggest such refinements as deemed necessary. The reports of these committees are expected within sixty days. The Board will then make its final recommendations and submit the most significant changes for referendum to the membership.

I. RECENT HISTORY OF CME RULE ENFORCEMENT

It is imperative at the outset to provide a brief review of the CME's long-standing efforts to keep its surveillance procedures and disciplinary standards at a level of which it can be proud. Indeed, in this respect, the Special Committee to Review Trading Practices concluded, among other things, the following:

A. That the vast majority of transactions on the Chicago

Mercantile Exchange are conducted in accordance with federal law, Exchange rules and high ethical standards;

B. That the underlying and substantive value of futures and options markets is not called into question because of the activities that are the focus of the current federal investigation;

C. That the Chicago Mercantile Exchange continues to be committed to adopting reforms necessary to ensure the public's trust and confidence in its markets;

D. That the Chicago Mercantile Exchange continues to be committed to strengthening and enhancing its trading procedures and practices; and

E. That the Chicago Mercantile Exchange continues to be committed to enhancing its detection and prosecution procedures and to vigorously punishing violators of its rules.

Specifically, in 1986, at the urging of the CFTC, the CME created and implemented its Computerized Trade Reconstruction (CTR) system in order to create an independently verifiable audit trail of the time of each trade. The CME chose a system that made use of time information that was supplied by independent parties rather than the brokers and traders who were the subjects of the audit that was to be performed.

The CME's program routinely uses seven separate checks to determine the time of each trade and has reached a level where 85% of all trades are assigned times that are verifiably accurate. The CME has created a series of computer programs to review the trades in order to flag potential rule violations for further review by the compliance staff.

In 1987, the CME took a series of strong actions to enhance the effectiveness of its rule enforcement program. It hired, trained, and placed compliance staff in the trading pits on a full-time basis. The job of these investigators included making observations that might discover improper conduct as well as following up on leads generated by the computerized portion of the surveillance system.

We enacted stringent rules requiring registration of broker groups and imposed limitations on their ability to trade amongst their members. We also created several programs to monitor compliance with these new rules and empowered a committee to enforce them.

The CME greatly expanded the powers of its Compliance Department. All members were required to submit to tape recorded interviews upon request. Members were required to produce books and records within thirty days or face charges of a major rule violation. A panel of experts was created to serve as consultants to the Compliance Department in respect to the more esoteric trading practices and schemes.

We enacted a much harsher penalty structure and adopted a strict enforcement policy. The positive results of these actions, we believe, are evidenced in the report of the U.S. Government Accounting Office, submitted to this Committee on Thursday, February 23, 1989 and in the report of the CFTC submitted to the Committee on March 7, 1989.

In addition to the foregoing, the entire transaction system for the Standard and Poor's 500 futures contract was examined and revised. In what amounted to a dramatic break with status quo, dual trading was effectively banned from the CME equity futures contract by the adoption of the so-called "top-step" rule which affected approximately 90% of public transactions in that market.

II. DUAL TRADING

The issues you asked the CME to discuss do not directly relate to dual trading except insofar as the existence of dual trading may be thought to affect "confidence in the marketplace." Nonetheless, the focus of national debate and industry interest is the dual trading issue. We would be remiss if we did not address it in the context of the report by the CME Special Committee to Review Trading Practices.

Dual Trading — the practice of a floor broker who executes customer orders and trades for his own account on the same day— is not unique to the Chicago Mercantile Exchange. Every U.S. futures market and virtually every futures market worldwide allow dual trading in one form or another. Most securities exchanges allow dual trading by certain classes of members on the floor. Dual trading is widespread and accepted as a necessary and legitimate part of the business of all major securities brokerage firms. Dual trading pervades financial markets and the firms that deal for customers on those markets.

Heretofore, the CME has defended dual trading on the basis of the following:

A. That the practice of dual trading is commonplace to financial exchanges worldwide;

B. That the practice of dual trading is a critical element in ensuring futures market liquidity; and

C. That the CME's surveillance programs are sufficient to deter and detect violations resulting from dual trading.

While the foregoing is still valid, the Special Committee found it painfully evident that the public image of futures markets and their members has been adversely impacted by the widely-held belief that dual trading in futures leads to customer abuses. All past efforts to explain the rationale for the CME's continued acceptance of dual trading have proved inadequate. Moreover, it has been argued that, as the transaction volume grew in the CME's major markets, the need for dual trading to provide liquidity in those major markets became a less important consideration.

The Special Committee acted on the basis of the information available to it, testimony of expert witnesses, and its perception of the current legislative and political climate. The information relied upon was provided by the CME's Research Department. That information and the conclusions derived were not readily available until the CME had changed the trading rules for its S&P futures pit (effective June 1987) so that a before and after study could be done.

The Committee, however, recognized that the S&P experiment tested the impact of a dual trading limitation only with respect to a highly liquid contract, one that averaged approximately 70,000 contracts per day. It also recognized that the conclusions were based on a financial contract and one dealing only with equity business. Thus, the Special Committee recognized that the conclusions drawn from that test may not be applicable to less active contracts with insufficient liquidity to withstand any reduction, or to other sectors of trade. Moreover, the Committee was convinced that dual trading is necessary to maintain adequate liquidity in less actively traded contracts as well as under special circumstances.

Accordingly, it was the Committee's opinion that a dual trading prohibition be instituted, but only for mature, highly liquid contracts. Furthermore, recognizing the dangers implicit in such action, the Committee mandated that the decision-making power in this respect be left exclusively to the CME Board of Governors; that the Board is best placed to determine which contracts meet the necessary criteria for such a prohibition. Moreover, that the Board should retain the flexibility to alter its list of designated contracts as conditions may warrant.

Toward this end, the Committee recommended that the Board of Governors:

A. Make a "Mature Liquidity" (ML) declaration for each contract month (futures and options) for every market that in its judgment has reached a level of maturity, transaction volume, and constancy of bids and offers that is sufficient to maintain an efficient and viable market without dual trading.

B. Use as criteria for ML declarations its experience, market conditions, advice and analysis of the CME Research Department, and the opinions of the user community, brokers, traders and experts of the product in question.

C. Review ML declarations on a timely basis, withdraw, reinstate, and make new ML declarations as necessary.

The Committee was convinced that certain exemptions to the dual trading ban are appropriate.

1. Customer Choice. While the Committee recommended banning dual trading in mature liquid months, it believed that a customer should have the option of permitting a member who trades for his own account, to act as a broker for that customer's order. Accordingly, the Committee recommended an exemption for members who have received permission from a customer in writing, such permission to be renewed annually.
2. Non-Public Trades. The Committee found no good reason to prohibit a member, who trades for his own account, from filling orders for other members since public customer order execution is not affected. Members of the Exchange are in a better position than public customers to monitor the execution of their orders.
3. Spread Transactions. The Committee recognized that spread trading is a specialty; that floor brokers, who execute spread orders need the ability to trade for their own account in order to effectively execute such transactions. Accordingly, the Committee recommended an exemption for floor brokers who predominantly execute spread orders between mature, liquid months and non-liquid months.

The Committee also recognized that it may be necessary for the Board of Governors, upon further consideration, to grant other categories of exemptions to dual trading restrictions.

While the CME is voluntarily considering this significant structural change in the transaction process, it is our considered opinion that it would be a serious mistake to enact any broad federal legislation or regulation that would absolutely ban dual trading. A total ban would not be responsive to the needs of the range of futures markets. The balance between the contribution of dual trading to liquidity and the perceived dangers to customers is extremely delicate. In the absence of evidence that dual trading is a significant source of fraudulent or abusive practices, the extent of any restriction of dual trading should be left to the individual exchanges.

Dual trading is an important part of the way our business has evolved and grown. The CME Special Committee's recommendation to restrict dual trading in mature, liquid markets is a statement that change can be made under certain conditions without a severe impact on liquidity and the ultimate usefulness of the market. However, if such constructive change is to occur, it must be left to each contract market to prescribe, institute and administer. Just as in the case of margins, dual trading must remain the exclusive province of the exchanges. Each exchange must be allowed the latitude to sculpt the dual trading issue to its particular needs and to quickly and efficiently adjust the proscription as circumstances change. Any other approach is fraught with serious danger to the marketplace.

III. EFFECTIVENESS OF CURRENT SURVEILLANCE SYSTEMS

You asked us to assess the effectiveness of our current surveillance systems in detecting trading abuses on the exchange floor. Our answer is that we believe that our surveillance systems are good but can be improved.

The Special Committee recommended an extensive list of substantive modifications intended to bring us to a true state of the art level and afford us the flexibility to maintain that level as technology improves. As previously noted, the CME is now in the process of reviewing these recommendations.

Before presenting a complete assessment of those suggestions for change, I would like to respond to your direct inquiry respecting the degree to which our current system may depart from the ideal. Surely you are all aware that no amount of money, effort or good faith can deter or discover and punish each and every rule violation.

The CME has not absolutely prevented its members and clearing members from violating its rules, CFTC Regulations or the law. During 1987 and 1988, the CME opened 260 trade practice investigations and secured convictions of 188 individuals. A large portion of these investigations and prosecutions were a direct result of information provided by our internal computerized surveillance system and floor monitors (23%) and by information provided by member and non-member informants (77%). The fines imposed by the CME for such trade practice prosecutions since January 1, 1987 total $3,479,925.

These results are a clear indication of the CME's strict rule enforcement policy. They are results of a tough stance against violators, one that compares favorably with any other futures exchange in the nation. Nor can it be argued that these results simply imply that there are more violators at our exchange than at other exchanges. Such a cynical view has no basis in fact and runs contrary to logic which dictates that trade practices and ethics of members on all exchanges tend to be similar.

While these raw statistics are impressive testimony to the past efforts of the CME and its compliance department, they only tell half of the story. A true assessment of a surveillance system requires that violations be graded according to their potential for harm to customers, the market, and other members. The first priority of the CME and its surveillance system has been to protect the public customers of its markets. Our most intense efforts and the bulk of our resources have been devoted to the protection of public customers. We believe that our current systems have been highly effective in deterring, detecting and punishing rule violations that injure public customers of our markets. We are aware, however, that there have been a number of technical violations that have not injured customers that have gone undetected and unpunished. In particular, everyone connected with auction markets is aware that there is a certain amount of trading that continues after the final bell. The newspapers have had a field day with allegations about the horrors of "curb" trading. It is a technical violation and we do devote effort to preventing it. However, it is not at the top of our enforcement priorities since such transactions do not injure public customers.

It is fair to say that our current systems are particularly adapted to dealing with trading patterns likely to be related to customer abuses. We do not pretend that we can detect and successfully prosecute every isolated violation. Nor do we believe it would be in the best interests of our enforcement program to publicly discuss the patterns that attract the attention of our investigators.

IV. SPECIAL COMMITTEE RECOMMENDATIONS FOR SURVEILLANCE IMPROVEMENTS

The Special Committee to Review Trading Practices recommended a substantial increase of full-time floor surveillance staff in order to provide greater coverage of all trading areas, including maximum coverage of market openings and closes. The Committee recommended that the floor surveillance staff be granted express authority to request trading cards and orders from floor traders, floor brokers, and clearing member representatives for the purpose of immediate inspection on the trading floor. It also recommended that the floor surveillance staff be granted express authority to copy immediately any document requested pursuant to its authority. And, it proposed an increase in the number of compliance investigators commensurate with any material increase in the number of matters necessitating review generated as a result of additional floor surveillance staff.

The Exchange also employed security consultants to assess the usefulness of electronic surveillance, but the Committee was not satisfied with the results. It therefore suggested that the Compliance Department employ the existing camera, used currently for security purposes, on the floor for a three-month period. The camera would be used in conjunction with its targeted investigative programs. A report would be made to the Board on the usefulness of the system, with a view toward expanding the video surveillance system if successful.

The Committee recognized the need to have an accurate audit trail to enable staff to reconstruct trading for detection and prosecution purposes. The Exchange's present CTR system has proved its ability to generate numerous reports that have assisted the Exchange in trade practice surveillance of such activities as trading ahead, crossing orders, trading against, wash trading and accommodation trading. The changes proposed by the Committee are intended to enhance the Exchange's audit trail system.

A. Openings and closes would be separately bracketed. Thus, trades occurring in openings and closes would be timed to within one minute of execution. This would dramatically enhance the audit trail for these time periods and also enhance the audit trail of other periods since more accurate times would be available for CTR processing. This change would also enhance staff's ability to review these trade periods for violations.

B. Hourly pick-up of trading cards would allow the Exchange to enhance its intra-day matching operations, and reduce the opportunity for a member to falsify a trading card in order to escape detection of a trade practice abuse.

C. Pre-printed and pre-numbered trading cards would have a beneficial impact. Floor trader data input to the system would be more accurate. The likelihood of trading card numbers being duplicated or of not being numbered at all would be eliminated. In addition, this requirement would make it impossible for a member to disguise a trading violation by mis-numbering or not numbering a card. Trading cards that are out-of-sequence or un-numbered would receive special scrutiny from the Compliance staff.

D. Uniformly time-stamped customer orders (e.g., time-stamp "in" on front and time-stamp "out" on back) were proposed. The accuracy of times that are utilized by CTR would be enhanced.

E. Spread brokers and traders would be required to specially designate spread trades. The audit trail for these trades would be enhanced, thereby improving the compliance staff's review process.

The Committee also proposed a number of other changes aimed at enhancing the audit trail system and suggested that if, after all these recommendations have been implemented, there is not a measurable improvement in the verifiable accuracy (at least 90%) of audit trail reconstruction, that a 15-minute bracket be adopted.

V. DETERRENT IMPACT OF CURRENT SYSTEMS

The Committee also asked us to assess the effectiveness of Exchange and CFTC disciplinary programs in deterring "such" abuses. This is not a question that can be answered with confidence. The term "such abuses" is not defined. But, more importantly, it is rarely possible to calculate the influence of a single variable in a complex interdependent system. We are well aware that our rules are occasionally violated; after all, we prosecuted and convicted 188 individuals during the past two years. However, it is totally misleading to reason that a disciplinary program has failed in its deterrent function simply because violations continue. There is a level beyond which no system can provide results.

During the past several years, at the same time as the CME's Board of Governors was enhancing its surveillance and disciplinary programs, it also acted to intensify the deterrent impact of those programs. First, surveillance staff became a visible presence in the trading pits. Second, fining authority was increased by between 100 and 500%. And third, a policy of actively publicizing violations, the actual conduct involved and the penalties imposed was created and implemented. No other major futures exchange has taken such steps, which we proudly and immodestly feel were a major contribution to the system of self-regulation.

Also, a reasonable assessment requires separate consideration of the various types of violations. Some have contended that the existing disciplinary programs have not been effective in deterring violations that are deemed by members to be entirely technical in nature. The real solution to such problems may be to regulate the behavior rather than trying to prohibit it. This was the conclusion of the Special Committee which decided that special procedures need to be instituted, for instance, on closes to deal with conduct that constitutes technical violations but which does not cause any palpable injury.

The more important question is to assess the effectiveness of the programs in deterring behavior that injures customers or that depreciates the value of futures markets. Deterrence is a long-run rather than a short-term measure. The CME's major increase in penalties was made effective as of June 22, 1987. As is the case with any deterrent system, it is to be expected that the effect of the penalties will only make themselves felt over time as members learn of the fines and come to realize that they will be subject to those same penalties if they violate Exchange rules.

VI. SPECIAL COMMITTEE RECOMMENDS ADDITIONAL DETERRENTS

The Special Committee concluded that additional actions might increase the deterrent effect of the CME's compliance program.

The Committee recommended that the number of compliance staff on the floor be doubled and their authority markedly increased. It suggested that staff be present to observe openings and closes. The presence of staff is intended to deter violations as well as to detect them. Staff's authority to demand and copy orders and trading cards should augment their impact.

A test of video cameras as an investigative tool was recommended. The membership will be informed that cameras are being used to observe trading practices. It is expected that the awareness of that surveillance should act as much as a deterrent as an investigative tool.

A record of each member's reported trading activity would be made available for review by other members who witnessed the actual transactions. This is intended to convince members that they will be unable to trade other than by competitive open outcry.

Members would be required to turn in trading records promptly after the transactions and to make such records on pre-printed, numbered cards. These procedures will severely reduce the opportunity to falsify a trading card in order to escape detection of a trade practice abuse.

Most significantly, the Committee recommended that non-members be appointed to the major disciplinary committees of the Exchange and provided a minimum penalty guideline for all offenses that cause financial injury to customers. These penalties are so severe that the deterrent effect should be immediate.

And finally, the Special Committee asked the Exchange to improve its current floor education program and extend it to existing members as well as new members. All members would attend periodic programs on trading rules, federal and administrative sanctions for violating rules, and the ethical obligations that come with membership on a major financial institution.

VII. CONCLUSION

The foregoing testimony is long and technical. But, the issues in question deserve that kind of consideration. These are not matters that can be fixed by quick, emotional responses. Slogans and emotional media appeals to public outrage are not appropriate where markets of vital national interest are concerned.

The Chicago Mercantile Exchange is firmly convinced that it has met and will continue to meet its self-regulatory responsibilities. Our Special Committee to Review Trading Practices has been thorough and responsible. Its recommendations have struck an appropriate balance. We submit that the CME Board and membership have the expertise and ability to refine and finalize these recommendations. We are prepared to proceed with the process.

REPORT OF THE

CHICAGO MERCANTILE EXCHANGE

SPECIAL COMMITTEE
TO REVIEW
TRADING PRACTICES

TO THE BOARD OF GOVERNORS

WEDNESDAY, APRIL 19, 1989

CHICAGO MERCANTILE EXCHANGE

CHICAGO MERCANTILE EXCHANGE

April 19, 1989

Board of Governors
Chicago Mercantile Exchange
30 South Wacker Drive
Chicago, Illinois 60606

Gentlemen:

We, the undersigned, having been appointed by the Board of Governors of the Chicago Mercantile Exchange to the Special Committee to Review Trading Practices, hereby file our report and recommendations this 19th day of April, 1989.

The Special Committee
to Review Trading Practices

JOHN T. GELDERMANN
Chairman

Susan M. Phillips
SUSAN M. PHILLIPS
Co-Vice Chairman

LEO MELAMED
Co-Vice Chairman

Thomas F. Eagleton
THOMAS F. EAGLETON

DONALD BUTLER

Louis Margolis
LOUIS I. MARGOLIS

JOHN A. WING

JOHN F. SANDNER

William J Brodsky
WILLIAM J. BRODSKY

Robert K. Wilmouth
ROBERT K. WILMOUTH
Special Advisor

TABLE OF CONTENTS

PREAMBLE . . . . Section I

SUMMARY OF MAJOR RECOMMENDATIONS FOR TRADING PRACTICES AND RULE ENFORCEMENT REFORMS . . . . Section II

SUMMARY OF MAJOR RECOMMENDATIONS FOR MARKET PROCEDURE ENHANCEMENTS . . . . Section III

RECOMMENDATIONS FOR TRADING PRACTICES AND RULE ENFORCEMENT REFORMS . . . . Section IV

RECOMMENDATIONS FOR MARKET PROCEDURE ENHANCEMENTS . . . . Section V

ADDITIONAL VIEWS OF THOMAS F. EAGLETON . . . . Section VI

COMPOSITION OF THE SPECIAL COMMITTEE . . . . Section VII

EXPERT WITNESSES WHO TESTIFIED BEFORE THE SPECIAL COMMITTEE . . . . Section VIII

EXPERTS WHO SUBMITTED WRITTEN TESTIMONY TO OR WHOSE WRITTEN WORK WAS CONSIDERED BY THE SPECIAL COMMITTEE . . . . Section IX

APPENDICES

Request, Dated March 9, 1989, from Senator Patrick J. Leahy, Chairman, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, to the CFTC Requesting Comments on Various Proposals to Tighten Oversight of Floor Trading. (Appendix A)

News Release, Dated February 1, 1989, from Congressman E. (Kika) De La Garza, Chairman, Committee on Agriculture, U.S. House of Representatives, Respecting Inquiry into the Futures Markets. (Appendix B)

News Release, Dated February 9, 1989, from Congressman Glenn English, Chairman, Agriculture Subcommittee on Conservation, Credit and Rural Development, U.S. House of Representatives, Respecting Inquiry into the Futures Markets and CFTC Reauthorization. (Appendix C)

Letter, Dated February 7, 1989, from Andrea M. Corcoran, Director, Division of Trading and Markets, CFTC, to William J. Brodsky, President, CME, Respecting List of Potential Regulatory Issues for the CME and Other Exchanges to Consider. (Appendix D)

Summary Statement of Testimony of Richard L. Fogel, Assistant Comptroller General, U.S. General Accounting Office (GAO), Before the Committee on Agriculture, Nutrition and Forestry, U.S. Senate, February 23, 1989. (Appendix E)

GAO Charts. Appended to Richard L. Fogel's Summary Statement. (Appendix F)

Letter, Dated March 8, 1989, from Andrea M. Corcoran to William J. Brodsky, Respecting Audit Trail and Related Issues. (Appendix G)

Summary of Dual Trading Practices at Other Exchanges, Prepared by the Chicago Mercantile Exchange Research Department, April 11, 1989. (Appendix H)

(Editor's note.--The appendices material is retained in the committee file.)

I

CHICAGO MERCANTILE EXCHANGE SPECIAL COMMITTEE TO REVIEW TRADING PRACTICES REPORT TO THE BOARD OF GOVERNORS

PREAMBLE

I. COMMITTEE CHARGE.

At its Special Meeting on Wednesday, January 25, 1989, the Board of Governors of the Chicago Mercantile Exchange (CME) voted unanimously to respond constructively to the widely publicized federal investigation of futures markets. The CME Board determined that the federal investigation provided an opportunity for a comprehensive review of all CME trading rules, trading practices, surveillance systems and enforcement standards. Toward this end, the Board directed the formation of a Special Committee.[1]

The Special Committee to Review Trading Practices was charged and empowered to study the entire structure of CME trading rules and practices, surveillance systems and enforcement standards in order to formulate recommendations for change.

II. BACKGROUND.

The Special Committee to Review Trading Practices held numerous meetings, three of which were held to receive testimony from and to question more than forty expert witnesses.[2] The expert witnesses who testified included representatives from the FCM (Futures Commission Merchant) community, the legal community, a diverse group of users, the academic community and the CME's floor broker and trader community.

Expert witnesses were encouraged to testify on any trade practice-related topic and expressly requested to provide input on specific issues; e.g., dual trading, broker associations, customer pressure for guaranteed prices, market openings and closes, fast markets, electronic surveillance, as well as disciplinary matters, including committee composition and minimum sentencing guidelines. In addition to the oral and written testimony provided by the expert witnesses who appeared before the Committee, the Committee also received extensive written testimony from other experts within and outside the industry.[3]

The Committee also reviewed the last three rule enforcement reviews conducted by the Commodity Futures Trading Commission (CFTC) covering various periods from 1985 to 1988 and the CME's responses to those reviews. Other documents and letters were reviewed by the Committee, including:

A. Request, Dated March 9, 1989, from Senator Patrick J. Leahy, Chairman, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, to the CFTC Requesting Comments on Various Proposals to Tighten Oversight of Floor Trading.

B. News Release, Dated February 1, 1989, from Congressman E. (Kika) De La Garza, Chairman, Committee on Agriculture, U.S. House of Representatives, Respecting Inquiry into the Futures Markets.

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[1] *See* Section VII for the composition of the Special Committee to Review Trading Practices and biographies of Committee members.

[2] *See* Section VIII for a list of expert witnesses who testified before the Special Committee to Review Trading Practices.

[3] *See* Section IX for a list of experts who submitted written testimony to or whose written work was considered by the Special Committee to Review Trading Practices.

C. News Release, Dated February 9, 1989, from Congressman Glenn English, Chairman, Agriculture Subcommittee on Conservation, Credit and Rural Development, U.S. House of Representatives, Respecting Inquiry into Futures Markets and CFTC Reauthorization.

D. Letter, Dated February 7, 1989, from Andrea M. Corcoran, Director, Division of Trading and Markets, CFTC, to William J. Brodsky, President, CME, Respecting List of Potential Regulatory Issues for the CME and Other Exchanges to Consider.

E. Summary Statement of Testimony of Richard L. Fogel, Assistant Comptroller General, U.S. General Accounting Office (GAO), Before the Committee on Agriculture, Nutrition and Forestry, U.S. Senate, February 23, 1989.

F. GAO Charts. Appended to Richard L. Fogel's Summary Statement.

G. Letter, dated March 8, 1989, from Andrea M. Corcoran to William J. Brodsky, Respecting Audit Trail and Related Issues.

H. Summary of Dual Trading Practices at Other Exchanges, Prepared by the Chicago Mercantile Exchange Research Department, April 11, 1989.

III. GUIDING PRINCIPLES FOR COMMITTEE RECOMMENDATIONS.

In making its final recommendations, the Special Committee recognized:

A. That the vast majority of transactions on the Chicago Mercantile Exchange are conducted in accordance with federal law, Exchange rules and high ethical standards;

B. That the underlying and substantive value of futures and options markets is not called into question because of the activities that are the focus of the current federal investigation;

C. That the Chicago Mercantile Exchange continues to be committed to adopting reforms necessary to ensure the public's trust and confidence in its markets;

D. That the Chicago Mercantile Exchange continues to be committed to strengthening and enhancing its trading procedures and practices;

E. That the Chicago Mercantile Exchange continues to be committed to enhancing its detection and prosecution procedures and to vigorously punishing violators of its rules;

F. That futures and options markets provide a risk management tool that is indispensable in today's economic environment;

G. That the futures industry, measured in terms of the volume of trading and the types of contracts traded, has grown at a dramatic rate;

H. That technology has grown more sophisticated and its potential as a market monitoring tool needs to be re-examined;

I. That the torrent of publicity growing out of the federal investigation did not allow the luxury of time, but demanded expeditious review and action; and

J. That the Special Committee will have completed its work before the results of the federal investigation are known, and it is therefore essential that the Chicago Mercantile Exchange review the information produced by the federal investigation and directly deal with any issues that may not have been considered by the Special Committee.

IV. COMMITTEE RECOMMENDATIONS.

The Special Committee report contains two categories of recommendations:

A. Recommendations for trading practices and rule enforcement reforms which the Committee believes should be adopted by the CME Board of Governors.[4]

B. Recommendations for market procedure enhancements made by expert witnesses appearing before the Committee which the Committee believes should be considered by the CME Board of Governors.[5]

V. IMPLEMENTATION BY THE CHICAGO MERCANTILE EXCHANGE BOARD OF GOVERNORS.

The Special Committee recognizes that some of its recommendations are of a nature that will result in major structural changes. Accordingly, the Committee acknowledges that these recommendations will require careful analysis by the Chicago Mercantile Exchange Board of Governors. The recommendations may further require refinement and fine-tuning as well as the adoption of a policy for implementation that will result in a minimum of disruption to the markets.

[4] A summary of the Special Committee's recommendations is contained in Section II. A complete list of the recommendations and the Committee's rationale is contained in Section IV.

[5] A summary of the Special Committee's recommendations is contained in Section III. A complete list of the recommendations and the Committee's rationale is contained in Section V.

II

SUMMARY OF MAJOR RECOMMENDATIONS FOR TRADING PRACTICES AND RULE ENFORCEMENT REFORMS[6]

I. TRADING PRACTICES.

A. Ban the practice of dual trading for all mature, highly liquid contract months in both futures and options.

B. Ban members of a broker association from trading for their personal account in all Exchange markets against orders executed by members of the same broker association.

C. Ban verbal orders between members.

II. TRADING SURVEILLANCE.

A. Provide all trade data, including related CTR (Computerized Trade Reconstruction) times, for review by members on the trading floor.

B. Increase the number of full-time floor surveillance staff to ensure coverage of all trading areas, including maximum coverage of market openings and closes.

C. Expand the authority of the floor surveillance staff to include immediate inspection of all trading floor documents, including customer orders and trading cards.

D. Authorize the hiring of additional Compliance staff.

E. Explore the feasibility of electronic surveillance for investigative purposes.

III. DISCIPLINARY PRACTICES.

A. Appoint non-members to all major disciplinary committees.

B. Adopt penalty guidelines for rule violations involving financial injuries to public customers.

1. Major rule violations.
    a. First offense—Six months suspension of all membership privileges; and
    b. Second offense—Expulsion.
2. Minor rule violations.
    a. First offense—Thirty days suspension of all membership privileges;
    b. Second offense—Six months suspension of all membership privileges;
    c. Third offense—One year suspension of all membership privileges; and
    d. Fourth offense—Expulsion.

C. Allow Compliance staff to appeal decisions of the Probable Cause Committee.

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[6] *See* Section IV for the complete "Recommendations for Trading Practices and Rule Enforcement Reforms" of the Special Committee to Review Trading Practices.

IV. COMPUTERIZED TRADE RECONSTRUCTION (CTR) ENHANCEMENTS.

A. Require separate time brackets for market openings and closes.

B. Require hourly pick-up of trading cards.

C. Require trading cards to have pre-printed, sequenced numbers on them.

D. Reduce present 30-minute brackets to 15-minute brackets if, after implementation of other recommendations, there is no measurable improvement in verifiable accuracy of audit trail trade reconstruction.

V. ADMISSION REQUIREMENTS.

A. Require more comprehensive background checks of membership applicants.

B. Require enhanced and formalized education and ethics programs for all members.

III

SUMMARY OF MAJOR RECOMMENDATIONS FOR MARKET PROCEDURE ENHANCEMENTS[7]

The testimony of expert witnesses before the Special Committee included recommendations to enhance market performance. While the Special Committee believes that these recommendations may enhance market performance and should be considered by the Board of Governors, it recognizes that significant research may be necessary before adoption and that implementation, in some cases, may be necessary on a pilot basis.

I. MARKET OPENINGS.

Permit brokers to cross opening orders within their own deck at the midpoint of the opening range. Evaluate a system of one-price openings.

II. MARKET CLOSES.

Allow a brief settlement trade session (e.g., two minutes) after the close of regular trading which would be open to all market participants and wherein all such transactions would be executed at the settlement price.

III. FAST MARKET DESIGNATION.

In order to highlight the CME's policy respecting the continuance of brokers' responsibilities to their customers during periods of market volatility, eliminate "fast market" designations. Study whether some other designation may be necessary to indicate highly volatile market conditions.

IV. LARGE ORDER EXECUTION PROCEDURES.

The Committee endorses the concept of large order execution procedures and recommends that the Exchange explore means to accomplish this.

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[7] *See* Section V for the complete "Recommendations for Market Procedure Enhancements" of the Special Committee to Review Trading Practices.

IV

RECOMMENDATIONS FOR TRADING PRACTICES AND RULE ENFORCEMENT REFORMS

I. TRADING PRACTICES.

A. Dual Trading.

1. Ban dual trading in all contract months that have reached a level of "Mature Liquidity" (ML) as determined by the Board of Governors on the basis of market conditions with the advice of the CME Research Department, industry experts and market participants.
2. Prohibit a member who begins the day by filling orders in an ML month from trading or having anyone else trade that day for his personal account in any month of the market within which the order was filled. However, allow a member who begins the day trading for his personal account to register to become a broker in an ML month at any time during the course of that day, but prohibit him from becoming a trader or having anyone trade for his account thereafter on that day.
3. Grant exemptions to the dual trading prohibition as follows:
   - a. To floor brokers who have received specific permission annually, in writing, from the ultimate customer, which specifically identifies the broker;
   - b. To floor brokers, on an annual basis, who predominantly conduct spread business on a continuous basis between ML and non-ML months as determined by the Compliance staff; and
   - c. To floor brokers executing orders for other members.

RATIONALE FOR RECOMMENDATION

Dual Trading— the practice wherein a floor broker is permitted to execute customer orders and trade for his own account on the same day—is not unique to the Chicago Mercantile Exchange. Every U.S. futures market and virtually every futures market worldwide allows dual trading in one form or another. (See Appendix H.) Most securities exchanges allow dual trading by certain classes of members on the floor, and it is widespread and accepted as a legitimate part of the business of all major securities brokerage firms.

Dual trading pervades financial markets, including cash markets, and the firms that deal for customers on those markets.

Heretofore, the CME has defended dual trading on the basis of the following:

1. That the practice of dual trading is commonplace to financial exchanges worldwide;
2. That the practice of dual trading is a critical element in ensuring futures market liquidity; and
3. That the CME's surveillance programs are sufficient to deter and detect violations resulting from dual trading.

While the foregoing is still valid, it has become painfully evident that the public image of futures markets and their members has been adversely impacted by the widely-held belief that dual trading in futures leads to customer abuses. All past efforts to explain the rationale for the CME's continued acceptance of dual trading have proved ineffective. Moreover, it has been argued that, as the transaction volume grew in the CME's major markets, the need for dual trading to provide liquidity in those major markets became a less important consideration.

S&P 500 Futures Experience

On June 22, 1987, the CME was the first U.S. futures exchange to experiment with a dual trading prohibition. The CME adopted a rule, applicable to its S&P 500 Stock Index contract, which limited the top step of the S&P 500 futures pit to floor brokers and prohibited all top step brokers from trading for their own account. Since most S&P customer futures business must be conducted from the top step, this rule affected approximately 90 percent of S&P futures public customer transactions.

The Committee reviewed statistics with respect to trading in the S&P pit covering periods before and after the implementation of the rule banning dual trading on the top step. In particular, the distribution of price changes and the distribution of price runs were examined to determine whether the markets showed any signs of losing liquidity after the rule was implemented. If the frequency of large price changes or long price runs before a reversal increased after the rule, this could indicate a loss of liquidity.

The following points arise from an examination of the data:

1. The price changes **after** the rule change were slightly more tightly clustered around one tick than they had been before.
2. The price runs **after** the rule change were slightly more tightly clustered around short moves than they had been before.
3. The market characteristics were very similar before and after the rule change. There was no major change in average daily range or average daily volume in any of the samples examined.
4. There was nothing to suggest that the top step rule had any appreciable impact on liquidity, despite the fact that the percentage of volume done by dual traders fell from over 50 percent to approximately 10 percent because of the rule change.

The Committee recognizes, however, that the S&P experiment tested the impact of a dual trading limitation only with respect to a highly liquid contract, one that averaged approximately 70,000 transactions per day. The conclusions drawn from that test may therefore not be applicable to less active contracts whose liquidity is insufficient to withstand any reduction. The Committee is convinced that dual trading is a necessary practice in order to maintain adequate liquidity in less actively traded contracts as well as under special circumstances.

Accordingly, it is the Committee's opinion that a dual trading prohibition be instituted, but only with respect to mature, highly liquid contracts. Furthermore, the CME Board of Governors is best placed to determine which contracts meet the necessary criteria. The Board should retain the flexibility to alter its list of designated contracts as conditions may warrant.

Toward this end, it is recommended that the Board of Governors:

1. Make a "Mature Liquidity" (ML) declaration for each contract month (futures and options) of every market that in its judgement has reached a level of maturity, transaction volume, and constancy of bids and offers that is sufficient to maintain an efficient and viable market without dual trading.
2. Use as criteria for ML declarations its experience, market conditions, advice and analysis of the CME Research Department, and the opinions of the user community, brokers, traders and experts of the product in question.
3. Review ML declarations on a timely basis, withdraw, reinstate, and make new ML declarations as it deems necessary.

From the discussion and analysis provided by the CME Research Department, it is estimated that under present market conditions, the recommended dual trading ban would affect approximately 80 percent of all transactions on the CME. The Committee also recognizes that the Board of Governors may elect to implement the proposed dual trading ban on a market-by-market basis.

Limited Exemptions

The Committee believes that certain limited exemptions to the dual trading ban are appropriate. First, while the Committee recommended banning dual trading in mature liquid months, it believes that a customer should have the option of permitting a floor broker, who trades for his own account, to fill that customer's order. Accordingly, the Committee recommended an exemption for floor brokers who have received permission from a customer in writing, such permission to be granted annually.

Second, the Committee found no good reason to prohibit a member, who trades for his own account, from filling orders for other members since public customer order execution is not affected. Members of the Exchange are in a better position than public customers to monitor the execution of their orders.

Third, the Committee recognizes that spread trading and brokering is a specialty. The Committee also recognizes that floor brokers, who predominantly execute spread orders for customers between mature, liquid months (dual trading banned) and non-liquid months (dual trading allowed), create necessary liquidity in the non-liquid months when trading for their own account in two ways.

1. Spread brokers are willing to take positions in these non-liquid months, but need to be able to take an opposite position in a liquid month if the market turns against them. If spread brokers were prohibited from taking an opposite position in a liquid month because of a ban on dual trading, they would not trade in the non-liquid month, thereby reducing liquidity in those contract months where it is most needed.
2. Spread brokers often attempt to execute a spread order by executing one side of the order in the less liquid month first. If, after establishing one side of the position, the broker cannot execute the other side of the order, he must take the position established into his account and trade out of it at his own risk. If the broker were prevented from trading for his own account, he would be unwilling to establish a position in the first leg of the spread, thereby limiting his ability to execute the spread order.

These exemptions should be monitored carefully by staff, and violators of rules prohibiting trading ahead of or against customer orders should lose the privilege of dual trading.

The Committee recognizes that it may be necessary for the Board of Governors, upon further consideration over time, to grant other categories of exemptions to dual trading restrictions.

B. Broker Associations.

1. Ban members of a broker association from trading for their personal account in all Exchange markets with others in the same association executing customer orders. (For purposes of this dual trading restriction, only broker associations in which profits are shared are to be treated as associations.)
2. Maintain the current 25 percent limitation on the percentage of customer orders that a member of a broker association may fill opposite orders executed by other members of the same broker association across all CME markets.
3. Establish a broker association floor identification system in order to identify members belonging to the same association.
4. Establish registration procedures that will preclude the structuring of broker associations to avoid the rule's prohibitions or violate its spirit.

RATIONALE FOR RECOMMENDATION

Most experts appearing before the Committee were of the opinion that broker associations are beneficial to the marketplace because (1) the capital of the principals is committed to cover all errors by members of the association; (2) well-organized and managed broker associations can quickly respond to changing needs for brokers as the demand for services shifts from pit to pit; (3) such associations are among the few remaining entry points for talented newcomers who lack the capital to acquire a membership or a clearing member guarantee; (4) broker associations provide a training ground for new brokers; and (5) clearing members, in many cases, find it more expedient to deal with one association across the floor.

Additionally, the combination of better capitalization and the continuing long term commitment to their brokerage business appeared to have been a factor in the willingness of broker associations to fill orders in chaotic markets, such as those occurring in October 1987.

No evidence was received which suggested any deficiency in the current Exchange rules which require principals of broker associations to supervise their associates and make the principals responsible financially for errors and rule violations of broker association members. Furthermore, current Exchange rules also limit trading among the members of a broker association.

The Committee found no reason to recommend that broker associations be banned. However, because of the perception that a broker association member is likely to prefer trading with another member of his association, and to maintain consistency with the proposal respecting dual trading, the Committee is recommending that members of broker associations be prohibited from trading for their personal account against members of the same association executing customer orders, across all CME markets. (The present limitation on this type of trading is 15 percent.)

The Committee decided not to recommend changing the other trading restriction on broker associations, which prohibits a broker from executing more than 25 percent of his orders with other members of his association. Any additional limit on this type of trading (order-to-order) seems to promise few concrete benefits, but is likely to result in a situation where a broker may not be able to execute a customer order at the best bid or offer.

The Committee recommended the establishment of a floor identification system so that trading among members of a broker association would be readily apparent to other members.

C. Verbal Orders.

1. Prohibit verbal orders. The Committee recommends that all member-to-member orders originate from a trading desk and be time-stamped in a fashion similar to public customer orders. (This prohibition does not affect the hand-signalling of orders from a trading floor desk to a floor broker in the Exchange pits.)
2. Allow exemptions for options-futures combination trading and other spread strategies.

RATIONALE FOR RECOMMENDATION

While no witness questioned this long-accepted practice, the Committee concurred with the Compliance staff's concern that the practice could be abused to the detriment of a public customer by a broker who trades for another member's account ahead of a public customer's order. Since the verbal order is not mechanically time-stamped, there may be cases where there is insufficient physical evidence that the member's order was actually placed in advance of a customer's order.

In addition, by requiring that the member's order be time-stamped in a fashion similar to customer orders, the audit trail system will be enhanced. (This rule change will not affect the hand-signalling of orders from the trading floor desk to the pit. Current Exchange rules require that a hand-signalled order be in writing and time-stamped at the desk before or simultaneous with the hand-signalling of it into the pit.)

An exemption is being recommended for option-futures combination trading and other spread strategies because a member executing trades for his personal account or orders for customers may need to request another member to execute the other side of the spread. To require the member executing the spread to have one side of his trade or order time-stamped and entered from a trading desk would effectively prohibit this type of trading, which prohibition was considered entirely unjustified. Staff believed that the audit trail would be sufficient to detect abuses since the other side of the spread would be independently timed by the Exchange's CTR system.

II. TRADING SURVEILLANCE.

A. Reporting of Matched Trades for Review on Floor.

Require that trade data be made available on the floor for review by members as follows:

1. Data for trades cleared as of the prior day should be available for review approximately one hour after the market opening on the morning after the trade is matched;
2. Data for trades cleared as of the intra-day reconciliations should be available as soon as practicable; and
3. Data to be made available should include:
   - a. Executing floor broker or floor trader;
   - b. Opposite floor broker or floor trader;
   - c. Commodity;
   - d. Month;
   - e. Quantity;
   - f. Price;
   - g. Bracket;
   - h. Options-put or call indicator and strike price; and
   - i. CTR time for trade data cleared as of the prior day.

RATIONALE FOR RECOMMENDATION

Requiring the disclosure, on a next day basis, of all executed trades to members on the floor is intended to accomplish the following:

1. To ensure that members execute all orders through open outcry and in a competitive fashion;
2. To allow floor members better to monitor the trading activity of other floor members;
3. To give floor members the information they need to report possible instances of trade practice abuses to the Compliance Department; and
4. To enhance the resolution of out-trades by providing information on the floor on a timely basis.

B. Floor Surveillance.

1. Increase Floor Surveillance Staff.

   Increase from four to eight the number of full-time floor surveillance staff in order to provide greater coverage of all trading areas, including maximum coverage of market openings and closes.

2. Staff Authority.

   a. Grant Authority to Inspect Trading Cards and Orders on the Floor.

   Grant the floor surveillance staff the express authority to request trading cards and orders from floor traders, floor brokers, and clearing member representatives for the purpose of immediate inspection on the trading floor.

   b. Grant Authority to Reproduce Floor Documents.

   Grant the floor surveillance staff the express authority to copy immediately any document requested pursuant to its authority.

3. Authorize Hiring of Other Investigative Staff.

Increase the number of existing Compliance investigators commensurate with any material increase in the number of matters necessitating review generated as a result of additional floor surveillance staff.

RATIONALE FOR RECOMMENDATION

The Committee believes that floor surveillance staff not only act as an effective deterrent to trade practice abuses, but also are effective in providing information to the Compliance staff to enable it to detect and prosecute those abuses. The Committee is concerned, however, that the present number of floor surveillance staff is not large enough to provide full-time broad coverage and recommends that it be increased.

The Committee also believes that the staff's effectiveness will be dramatically enhanced if they have the express authority to request that members furnish trading cards and orders for immediate inspection and copying. This authority should enhance the deterrent effect of increased surveillance staff presence and result in the saving of the time it takes to request and receive trading cards and orders from clearing members.

The Committee recognizes that the timeliness of investigatory follow-up is a necessary component in an adequate system to detect and prosecute trading abuses. Since the Committee believes that additional floor surveillance staff may provide additional information to the Compliance staff respecting possible trading abuses, it is possible that more investigative staff will be necessary.

C. Electronic Surveillance.

The Committee reviewed the presentation of security consultants and, after extensive questioning, determined that the proposed system combining video and audio surveillance of the trading floor was not likely to be useful as a surveillance tool for the Compliance staff. The Committee was particularly unimpressed with the audio portion of the surveillance recordings. However, the Committee was generally in favor of testing the usefulness of video cameras capable of pan, tilt and zoom, in conjunction with particular investigations of activities on the trading floor.

The Committee, therefore, recommended that the Compliance Department employ the existing single camera, used currently for security purposes, on the floor for a three-month period. The camera should be used in conjunction with its targeted investigative programs. Finally, a report should be made to the Board on the usefulness of the system, with a view toward expanding the video surveillance system if successful.

RATIONALE FOR RECOMMENDATION

The Committee believes that effective camera surveillance will be a deterrent to trading abuses. Its usefulness in detecting or corroborating allegations of trading abuses should be tested.

D. Enhance Database to Further Assist Staff Review of Out-trades.

The Committee recommended the enhancement of the current database to further assist Compliance staff in monitoring out-trades and their resolution.

RATIONALE FOR RECOMMENDATION

The Committee recognizes that out-trades generally result in a loss to one of the parties. And, where the out-trade is resolved in favor of the floor broker and against the floor trader, there is the possibility that the resolution was accomplished by an explicit or tacit understanding that the floor broker will repay the floor trader by giving him preference on trades in the future. By creating a database of information respecting the entire history of an out-trade, staff's review of out-trades should be enhanced.

III. DISCIPLINARY PRACTICES.

A. Committee Composition.

1. Non-Members.

Appoint at least three non-members, with voting privileges, to each of the major disciplinary committees[8]. The appointments should be made from a pool of competent and qualified non-members established by the National Futures Association. Each non-Exchange member should serve for a term of no less than two years. One non-Exchange member should serve on each panel hearing a case.

2. Prohibit Appointment to Committees of Members Found Guilty of Rule Violations.

Prohibit members, who have been found guilty of major rule violations within the last five years or minor rule violations within the last three years, from serving on the Exchange's membership, disciplinary and floor education committees, including the following current committees:

a. Arbitration Committee;
b. Broker Association Committee;
c. Clearing House Committee;
d. Business Conduct Committee;
e. Commodity Representative/Customer Complaint Committee;
f. Computerized Trade Reconstruction Committee;
g. Floor Broker Qualification Committee;
h. Floor Orientation Committee;
i. Floor Practices Committee;
j. Membership Committee;
k. Pit Committees; and
l. Probable Cause Committee.

With respect to minor rule violations, allow the Board Chairman to make exceptions.

3. Limit Size of Major Disciplinary Committees.

Limit the number of committee members hearing a case by creating panels of five to seven members that would remain intact during their appointment and that would alternate in the hearing of cases.

4. Follow Current Rotation Policy.

Comply strictly with current policy of replacing approximately one-third of the members of the major disciplinary committees each year. After the expiration of their term, committee members should not be reappointed to the same committee for a period of at least two years.

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[8] Probable Cause Committee, Business Conduct Committee and Floor Practices Committee.

RATIONALE FOR RECOMMENDATION

The Committee noted that the sanctions issued by the CME's disciplinary committees appeared to be significant for the period 1985 through 1988 and were generally greater than those issued by other exchanges. (*See* Appendices E and F for GAO report and related charts.)

Nevertheless, the Committee recommends that non-members, with full voting privileges, serve as members of the major disciplinary committees. This will help to eliminate the public perception that the Exchange is a closed community that is not inclined to sanction its members appropriately.

Additionally, the Committee recommended that the National Futures Association (NFA) establish the pool from which the Exchange would select competent and qualified non-members. The NFA was chosen because of its expertise and impartiality in selecting representatives of the business and legal communities to serve on its existing disciplinary committees.

The Committee noted that Exchange Rule 434 prohibits members from serving on disciplinary and hearing committees for a period of two years after a finding of a major rule violation. In order to ensure that only those members who are committed to upholding Exchange rules are appointed to committees, the Committee recommended extending the period from two to five years, adopting a similar prohibition for three years for minor rule violations and extending the prohibition to membership and floor education committees. The Committee recognizes that with respect to minor rule violations, the Board Chairman may make exceptions.

The Committee believes that a rigorously followed rotation policy helps to ensure the participation of more members in the disciplinary process. In addition, the policy should eliminate any impression that important committees operate like "private clubs."

B. Penalty Structure.

Adopt the following penalty guidelines to be applied to members in each case where a public customer has been directly made to suffer a financial injury or disadvantage by reason of a violation of any of the following trading rules:

1. Major rule violations:[9]
    a. First offense—Six months suspension of all membership privileges; and
    b. Second offense—Expulsion.
2. Minor rule violations (including all non-major trading rule violations):
    a. First offense—Thirty days suspension of all membership privileges;
    b. Second offense—Six months suspension of all membership privileges;
    c. Third offense—One year suspension of all membership privileges; and
    d. Fourth offense—Expulsion.
3. A committee deciding not to follow the guidelines would have to explain its reasoning in the minutes of the meeting.

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[9] CME Major Rule Violations Include:
(a) Fraud or any act of bad faith (Rule 432.b.);
(b) Dishonest conduct (Rule 432.c.);
(c) Making or reporting a false or fictitious trade (Rule 432.d.);
(d) Acting as both buyer and seller in the same transaction (Rule 432.g.);
(e) Committing an act which is substantially detrimental to the interest or welfare of the Exchange (Rule 432.q.);
(f) Withholding a customer order from the market for the member's or another's benefit (Rule 529);
(g) Trading ahead of (Rule 530) or against (Rule 531) a customer's order;
(h) Disclosing a customer's order (Rule 532); and
(i) Pre-arranged trading (Rule 539).

RATIONALE FOR RECOMMENDATION

The severity of the sanctions relating to abuse of public customers underscores the Exchange's commitment to ensuring that every member understands completely the gravity of violating the public's trust.

Additionally, the Committee believes that severe sanctions will act as a deterrent to other members and will result in the expulsion of members who are repeat violators.

Finally, the Committee proposed penalty guidelines to ensure the fair and equal treatment of all members.

C. Probable Cause Committee Decisions.

Allow the Compliance staff to request that the Board of Governors review the decisions of the Probable Cause Committee.

RATIONALE FOR RECOMMENDATION

Because the process in which members are charged with rule violations is critical to the entire disciplinary process, the Committee recommends that the Compliance staff have the authority to seek review of Probable Cause Committee decisions.

The authority of the Compliance staff to seek review at the Board of Governors level will assure the balance between staff and committee members necessary for the self-regulatory process. The Committee recognizes the necessity of assuring the public that staff has sufficient autonomy to perform its regulatory function.

IV. COMPUTERIZED TRADE RECONSTRUCTION (CTR) ENHANCEMENTS.

A. Require Separate Time Brackets for Market Openings and Closes.

The notation of opening and closing brackets will further enhance the audit trail because those trades occurring during these brief and active periods will be distinguished by a special bracket from other transactions which occurred during the first and last half hours of trading.

B. Require the Hourly Pick-up of Trading Cards.

Requiring the pick-up of trading cards every hour will enhance the Exchange's clearing process and will shorten the time period during which members may hold onto their trading cards.

C. Require Pre-printed Numbered Trading Cards.

Pre-printed cards will prevent mistakes respecting the mis-numbering of trading cards or the absence of numbering.

D. Require Fifteen-Minute Brackets, If Necessary.

The Committee recommended that the CME institute 15-minute brackets if, after the implementation of the other recommendations, there is not a measurable improvement in the verifiable accuracy of audit trail trade reconstruction.

E. Require Uniform Time-Stamping by Clearing Members.

The Committee recommends that firms be required to time-stamp orders uniformly; e.g., "time-stamp in" on front and "time-stamp out" on back.

F. Require Floor Brokers and Traders to Designate Spread Trades.

The Committee recommends this requirement in order to enhance the audit trail for spread trades.

RATIONALE FOR RECOMMENDATION

The Committee recognizes the need to have an accurate audit trail to enable staff to reconstruct trading for detection and prosecution purposes. The Committee recognizes that the Exchange's present CTR system has proved its ability to generate numerous reports that have assisted the Exchange in trade practice surveillance of such activities as trading ahead, crossing orders, trading against, wash trading and accommodation trading. These recommendations are intended to enhance the Exchange's audit trail system.

First, openings and closes generally are completed within one minute. Thus, trades occurring in openings and closes will be timed to within one minute of execution. This will dramatically enhance the audit trail for these time periods and will also enhance the audit trail of other periods since more accurate times will be available for CTR processing. This change will also enhance staff's ability to review these trade periods for violations.

Second, requiring the pick-up of trading cards every hour will:

1. Allow the Exchange to enhance its intra-day matching operations; and
2. Reduce the opportunity that a member has to falsify a trading card in order to escape detection of a trade practice abuse.

Third, by requiring that trading cards be pre-printed and pre-numbered, floor trader data input to the system will be more accurate. The likelihood of trading card numbers being duplicated or of not being numbered at all will be eliminated. In addition, this requirement will make it impossible for a member to disguise a trading violation by mis-numbering or not numbering a card. Trading cards that are out-of-sequence or un-numbered should receive special scrutiny from the Compliance staff.

Fourth, by requiring clearing members to uniformly time-stamp customer orders (e.g., time-stamp "in" on front and time stamp "out" on back), the accuracy of times that are utilized by CTR will be enhanced.

Fifth, by requiring spread brokers and traders to designate the trades as spreads, the audit trail for these trades will be enhanced, thereby improving the Compliance staff's review process.

Finally, the Committee, and all expert witnesses agreed, that an adequate audit trail is necessary to enable Compliance staff to detect and prosecute abuses effectively. Accordingly, the Committee recommended that if, after these changes have been implemented, there is not a measurable improvement in the verifiable accuracy (at least 90 percent) of audit trail reconstruction, a 15-minute bracket should be adopted.

Mr. Eagleton wished to go further. He offered the following firm position:

> I strongly believe (in addition to CTR and all other recommendations in this section) that one-minute time bracketing, as initially proposed by the CFTC a decade or more ago, should be required.
>
> The essential requirement of any successful surveillance system is a verifiably accurate, time-sensitive audit trail. The Committee's recommendations are positive steps toward a better audit trail. One-minute time bracketing would be an additional positive step.

The Committee chose not to accept Mr. Eagleton's position for the following reasons:

1. One-minute time recordation by the floor broker and trader, who are the objects of surveillance, was deemed a questionable basis for a surveillance system. CTR was considered a superior technology because the objects of surveillance are not the primary sources of information. The Committee was convinced that the audit trail could be most effectively improved by enhancing the quality and quantity of information that is beyond the control of traders and brokers.
2. The implementation of universal time recordation by brokers and traders is likely to be a costly and disruptive change. Time recordation directly interferes with the ability of a broker to execute orders in active markets. Prior independent studies have indicated that the potential cost to customers of futures markets of requiring their brokers to record the time of trades far exceeds the potential benefit to those same parties.
3. The Committee was convinced that the systematic changes proposed would create an audit trail meeting all of the requirements that Mr. Eagleton feels are most desirable without, however, the unwarranted and costly impact on trading that is certain if one-minute time recordation is required.

V. ADMISSION REQUIREMENTS.

A. Application Procedures.

Require a member-applicant to apply for a floor broker's license with the National Futures Association, thereby requiring a more thorough background check, including a fingerprint check with the FBI.

RATIONALE FOR RECOMMENDATION

The Committee believes that the requirement for applicants to apply for a broker's license with the NFA, which will result in a background check by the FBI, will ensure that all of an applicant's history is reviewable by the Exchange's admissions committee. This will ensure that the Exchange rejects those applicants who are unfit for membership.

B. Floor Education Programs, Including an Ethical Responsibilities Section.

1. New Members.
   - a. Enhance current education programs for new members by emphasizing trading rules and procedures and federal and administrative sanctions for violating rules.
   - b. Design and implement a formal ethics program.
2. Existing Members.

   Require all existing members to attend periodically a program respecting trading rules, federal and administrative sanctions for violating rules, and their ethical responsibilities.

RATIONALE FOR RECOMMENDATION

The Committee believes that the Exchange's educational programs should be enhanced. It is important for members to understand that membership in the Exchange is a privilege that can be withdrawn for violations of its rules. Members must also understand that they have ethical responsibilities and obligations to customers of the Exchange.

It is the opinion of the Committee that it is insufficient to educate only new member-applicants of these requirements. Existing members should be reminded of them periodically.

V

RECOMMENDATIONS FOR MARKET PROCEDURE ENHANCEMENTS

I. MARKET OPENINGS.

A. Permit brokers to cross opening orders within their own deck at the midpoint of the opening range.

B. Evaluate a system of one-price openings.

RATIONALE FOR RECOMMENDATION

Expert witnesses representing the FCM and user communities consistently suggested that customers would be better served if floor brokers were permitted to cross orders on the opening at the midpoint of the opening range. The Committee agrees and believes that this will alleviate the perception held by public customers that their orders are executed at the worst possible price in the opening range. Additionally, it will offer a measure of relief to floor brokers who may be tempted to prearrange trades to ensure that customer orders are executed at the best possible price.

II. MARKET CLOSES.

A. Allow a settlement trade session for each market participant for a brief period of time (e.g., two minutes) after the close of regular trading and after the posting of the settlement price. Trades could only be executed at the settlement price, and a special bracket designation would be used to identify the trades.

B. Floor surveillance staff should be present during settlement trade sessions.

RATIONALE FOR RECOMMENDATION

The Committee recognizes that there may be several types of trading after the close:

1. An "evening-up" process between two floor traders that do not want to carry a position for their own account overnight, at worst, a technical violation that does not affect public customers; and
2. The execution of a customer order that arrives at the bell and which was intended by the customer to be filled, but was not.

By adopting a period after the close for trading at the settlement price, floor traders may "even-up" their positions legitimately and floor brokers may execute customer orders received late legitimately.

Since trading during this session must be done by open outcry in the pit and may only be done at the settlement price, floor surveillance staff, who should be present during these sessions, should be able to detect any instances of abuse more easily.

III. FAST MARKET DESIGNATION.

A. Eliminate "fast market" designations.

B. Study whether another designation is needed to signify highly volatile market conditions.

RATIONALE FOR RECOMMENDATION

The Exchange's policy of holding floor brokers to the same standard of performance in the execution of an order in fast markets as it does in other markets was misunderstood by most expert witnesses.

The Committee believed that the only way to ensure that market participants appreciate the distinction between the CME's policy versus that of other exchanges is to eliminate the "fast market" designation. The Committee suggested, however, that the Exchange study whether another designation is needed to indicate to market participants whether existing market conditions are highly volatile.

IV. LARGE ORDER EXECUTION PROCEDURES.

The Committee endorses the concept of large order execution procedures and recommends that the Exchange explore means to accomplish this.

RATIONALE FOR RECOMMENDATION

Many of the expert witnesses testified that institutional users of the market believe that the crossing of large block orders will result in a more efficient marketplace and alleviate pressure to develop off-exchange markets.

Moreover, many market users are comfortable with the practice in securities markets of allowing prearrangement to facilitate the execution of block orders. Such market users, who have grown in importance and size, neither understand nor appreciate the Exchange's restriction. The Committee endorses the concept.

VI

ADDITIONAL VIEWS OF THOMAS F. EAGLETON

These recommendations and the investigation which preceded them mark a milestone in the evolution of commodity futures self-regulation. The Special Committee's study was more intense and far-ranging than any previously conducted by a commodities exchange. As a result, we are recommending, in one fell swoop, a vast array of changes in trading practices as well as compliance procedures.

This most substantial effort is designed to further assure that the business transacted on the Chicago Mercantile Exchange is done with the utmost efficiency and integrity. I urge the CME to adopt and fully implement all of the Special Committee's recommendations. The investing public should expect no less of this successfully innovative institution. However, vital work remains to be done by others.

The trading exchanges have the initial duty to keep their own houses clean. That's self-regulation. But when it comes to the policing of millions of public transactions involving billions of dollars, then the government must effectively play its responsible oversight role. Government—in this instance, the CFTC—must mandate standards sufficient to guarantee investor confidence and then vigilantly backstop the exchanges' effort to police those public marketplaces.

The CFTC should, in my opinion, mandate that standards no less rigorous than those set forth in this report be industry-wide standards. The CFTC is a small agency, with a small staff, but it has the large responsibility to supervise a bevy of independent minded exchanges which are exploding in transactional volume.

The CFTC labors under a burden unlike that of any other financial regulator. It has to fight regularly for its very existence. Congress in 1974 made the CFTC a "sunset" agency requiring reauthorization by Congress in four years. Since then Congress has made sunset review eternal, and in 1986 the agency was put on a three year sunset schedule. This drains the agency's resources and attention, and it implicitly questions its value.

The Congress should provide clear and forceful direction to the CFTC. First, take the CFTC off a short leash. Acknowledge that the CFTC fulfills an essential, permanent function and liberate the agency from its periodic, debilitating fight for life. Second, amend the statute to detail and underscore the agency's mission of assuring trade practice integrity. Third, significantly increase the CFTC staff and budget so as to reflect the enormous expansion in the volume and nature of trading that has occurred over the past 15 years.

In my opinion, this report is a first chapter. The CFTC and the Congress must write the rest.

VII

SPECIAL COMMITTEE TO REVIEW TRADING PRACTICES

I. COMMITTEE MEMBERS.

Chairman
JOHN T. GELDERMANN
Chairman, Board of Governors
Chicago Mercantile Exchange

Co-Vice Chairmen

DR. SUSAN M. PHILLIPS	**LEO MELAMED**
Former Chairman	Chairman, Executive Committee
Commodity Futures Trading	Special Counsel to the Board
Commission	Chicago Mercantile Exchange

THOMAS F. EAGLETON
Partner, Thompson & Mitchell

DONALD BUTLER
Former President
National Cattlemen's Association

LOUIS I. MARGOLIS
Managing Director
Salomon Brothers, Inc.

JOHN A. WING
President and Chief Executive Officer
The Chicago Corporation

JOHN F. SANDNER
Senior Policy Advisor
Chicago Mercantile Exchange
Board of Governors

WILLIAM J. BRODSKY
President and Chief Executive Officer
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II. SPECIAL ADVISOR TO THE COMMITTEE.

ROBERT K. WILMOUTH
President and Chief Executive Officer
National Futures Association

III. COUNSEL TO THE COMMITTEE.

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IV. CHICAGO MERCANTILE EXCHANGE STAFF.

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Executive Vice President & Chief Economist

GERALD D. BEYER
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EDWARD HASKINS
Vice President
Trading Floor Operations

PAUL O'KELLY
Vice President
Compliance

TODD PETZEL
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ALYSANN POSNER
Vice President
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ROBERT DUFFY
Director
Compliance

MARY C. MCGONAGLE
Attorney
Legal Department

JOHN T. GELDERMANN
CHAIRMAN OF THE BOARD OF GOVERNORS
CHICAGO MERCANTILE EXCHANGE

John T. Geldermann is an officer and the founder of Geldermann & Company, Inc. He has been a member of the Chicago Mercantile Exchange (CME) since 1961 and the Chicago Board of Trade from 1946 through 1984.

Mr. Geldermann served as Chairman of the Board of the CME in 1974 and 1975 and was elected to his third one-year term as Chairman in January 1989. Previous to his Chairmanship, Mr. Geldermann served as First Vice Chairman in 1972 and Second Vice Chairman in 1973. He has also served on the CME Executive Committee since 1976 and on the Board of Governors since 1968.

Throughout his tenure at the Exchange, Mr. Geldermann has chaired a number of committees, including the Live Cattle Committee, Floor Facilities Committee, Computer Committee, Lumber Committee and Floor Communications Committee. Additionally, Mr. Geldermann has been a member of the Clearing House Committee and the Quotations Committee. As Chairman of the CME's Real Estate Committee since 1976, Mr. Geldermann has guided the Exchange through its 1984 expansion and occupation of the new CME Exchange Center and its more recent administrative expansion into the North Tower of the same complex.

Mr. Geldermann has held continuous membership in the Futures Industry Association (FIA) from 1974 to the present, and served as its Chairman in 1977-1978. He is on the Board of Directors of Catholic Charities' Family and Neighborhood Services Committee and also serves on the Executive Advisory Board for St. Joseph's Hospital.

He attended Loyola University-Accounting and Business Law and served in the United States Army Infantry from 1943 to 1945.

Mr. Geldermann is married and has seven children.

SUSAN M. PHILLIPS
PUBLIC GOVERNOR
CHICAGO MERCANTILE EXCHANGE

Susan M. Phillips is Vice President for Finance and University Services and Professor of Finance at the University of Iowa.

Dr. Phillips began her association with the University of Iowa in 1974 as an assistant professor of Business Administration, after serving one year on the Louisiana State University faculty. Dr. Phillips spent 1976 as a Brookings Economic Policy Fellow and 1977 as an Economic Fellow with the Securities and Exchange Commission (SEC).

In 1978, Dr. Phillips returned to the University of Iowa as an associate professor. She was appointed acting Assistant Vice President for Finance and University Services in June 1980 and became Associate Vice President in the fall of 1980.

In November 1981, Dr. Phillips was nominated by the President and confirmed by the Senate to membership on the Commodity Futures Trading Commission (CFTC), becoming its Chairman in 1983. Dr. Phillips was reappointed as Commissioner and Chairman of the CFTC in 1985, serving until her resignation in July 1987 to return to the University of Iowa as Vice President.

Dr. Phillips received a B.A. degree in mathematics from Agnes Scott College. She received an M.S. degree in finance and insurance and a Ph.D. in finance and economics from Louisiana State University. Dr. Phillips was initiated into Beta Gamma Sigma at Louisiana State University and Phi Beta Kappa at Agnes Scott College.

Her areas of specialization include commodity futures and options, financial management and economic theory and regulation. Dr. Phillips has authored many scholarly publications, including *The SEC and the Public Interest,* written with J. Richard Zecher.

LEO MELAMED
CHAIRMAN OF THE EXECUTIVE COMMITTEE
CHICAGO MERCANTILE EXCHANGE

Leo Melamed, Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME), is widely-recognized as the founder and architect of financial futures. Under his leadership as Chairman of the CME (1969-1971), the Exchange pioneered the concept of financial futures and created the International Monetary Market (IMM), the first futures market for financial instruments. Mr. Melamed was Chairman of the IMM until its merger with the CME in 1976, when he became Chairman of the combined institution. In 1977, the CME Board created the special office he presently holds.

Mr. Melamed's role as chief policy maker of the CME helped propel the institution to the forefront of financial markets worldwide. In 1984, he spearheaded the concept of "mutual offset" which led to the CME link with the Singapore International Monetary Exchange (SIMEX). Later, in 1987, he led the CME in expanding this concept to a global "after hours" electronic trading system (GLOBEX) with Reuters Holdings PLC.

In 1982, Mr. Melamed led the futures industry toward the creation of a congressionally-sanctioned self-regulatory body, the National Futures Association (NFA), and became its Chairman. Mr. Melamed has been an advisor to the Commodity Futures Trading Commission (CFTC) and has lectured and written extensively on the subject of financial futures markets. He has also completed a science fiction novel, *The Tenth Planet,* which was published in September 1987. Mr. Melamed was Editor of *An Anthology: The Merits of Flexible Exchange Rates,* published in Spring, 1988.

On a business level, Mr. Melamed is an active futures trader and is Chairman of Dellsher Investment Company, a Futures Commission Merchant and clearing member of the CME and the Chicago Board of Trade. Mr. Melamed is an attorney, having received his Doctor of Laws Degree (JD) from the John Marshall Law School, Chicago, Illinois, 1955.

THOMAS F. EAGLETON
PUBLIC GOVERNOR
CHICAGO MERCANTILE EXCHANGE

Thomas F. Eagleton is University Professor of Public Affairs, Washington University, St. Louis, Missouri. He served as United States Senator from Missouri from 1969 to 1987. He was Lieutenant Governor of Missouri from 1965 to 1969 and was Attorney General of Missouri from 1961 to 1965. In addition to teaching political science, government and business, he is a member of the St. Louis law firm of Thompson & Mitchell.

Mr. Eagleton holds honorary doctorates from Amherst College, the University of Missouri, St. Louis University, Culver Stockton College, Washington University and others.

After service in the United States Navy, he received his Bachelor of Arts degree from Amherst College, cum laude, in 1950. In 1953, he received the LL.B. degree from Harvard Law School, cum laude.

DONALD BUTLER
INDUSTRY GOVERNOR
CHICAGO MERCANTILE EXCHANGE

Donald Butler, owner and operator of the Coronado Cattle Company in Tucson, Arizona, has been a leading national representative of the cattle industry for many years. He is the past President of the National Cattlemen's Association (NCA).

Previous to his term as President, Mr. Butler was Vice Chairman of the NCA's Marketing Committee and was a member of the Farm Policy Committee of the NCA Board.

Mr. Butler has been active in foreign affairs, through his involvement with the U.S. Meat Export Federation, an organization that he chaired. He is a member of the Advisory Committee for the U.S. Department of Agriculture Export Enhancement Program as well as the President's Advisory Council for Trade Negotiations.

He currently serves as Vice Chairman of the National Public Lands Advisory Council of the Department of Interior and is a past president of the Arizona Cattle Feeders Association.

Mr. Butler received a B.S. degree in animal husbandry from the University of Arizona.

LOUIS I. MARGOLIS
INDUSTRY GOVERNOR
CHICAGO MERCANTILE EXCHANGE

Louis I. Margolis is a Managing Director of Salomon Brothers, Inc. and Manager of its Equity Options and Futures Department. He joined the firm in 1979 as a member of its Institutional Options Sales Department.

Mr. Margolis has served on a number of futures industry advisory panels and boards, including the Commodity Futures Trading Commission (CFTC) Financial Products Advisory Committee, the National Options and Futures Society Board of Directors, and the Securities Industry Association Option and Futures Committee. Additionally, Mr. Margolis served on the Securities and Exchange Commission (SEC) Program Trading Round Table in 1986.

Mr. Margolis was born in New York City and received a B.A. degree in Economics from Columbia University in 1967.

JOHN A. WING
CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER
THE CHICAGO CORPORATION

John A. Wing became Chairman, President and Chief Executive Officer of The Chicago Corporation in 1981. He was previously President of A.G. Becker & Co., having been Director and Executive Committee member for the Becker Warburg Paribas Group. He had been an executive with A.G. Becker, Inc. since 1968, after working with the Securities and Exchange Commission (SEC) as an attorney and financial analyst.

Mr. Wing is currently on the Board of Directors of the Chicago Board Options Exchange, the Chicago Capital Fund, Inc., Evanston University Research Park, Inc., National Conference of Christians and Jews and the Illinois State Chamber of Commerce. He served on the Board of the Midwest Stock Exchange (1974-1976), the National Association of Security Dealers (1978-1980), and the Securities Industry Association (1984-1986).

Mr. Wing holds an LL.B. degree from George Washington University and a Bachelor of Arts degree from Union College. He is a member of the Illinois, District of Columbia and Virginia Bars and has been admitted to practice before the U.S. Supreme Court. He is a member of the Commercial Club of Chicago and the Economic Club of Chicago. He is also a member of the Chicago Board of Trade.

JOHN F. SANDNER
SENIOR POLICY ADVISOR TO THE BOARD
CHICAGO MERCANTILE EXCHANGE

John F. "Jack" Sandner served as Chairman of the Board of the Chicago Mercantile Exchange (CME) from 1980 to 1982, and was elected to his sixth one-year term as Chairman in January 1988—serving 1986 to 1988. He was appointed Senior Policy Advisor to the CME Board of Governors in 1989.

Mr. Sandner joined the CME as a member in 1971 and since then has served on twenty-six committees, including the CME International Steering Committee, Financial Instruments Steering Committee, Agricultural Steering Committee, Building Improvement and Real Estate and Special Real Estate Planning Committees, Political Action Committee, as well as other CME committees. Throughout his association with the CME, Mr. Sandner has chaired Arbitration, Business Conduct, Floor Facilities and Operation, Rules, Live Cattle and Probable Cause Committees.

Mr. Sandner is President and Chief Operating Officer of RB&H, Inc., a clearing member of the Chicago Mercantile Exchange, a position he has held since January 1978.

Born November 3, 1941, Mr. Sandner received his undergraduate Bachelor of Arts degree in 1965 at Southern Illinois University. He earned a Doctor of Jurisprudence degree from the University of Notre Dame in 1968 after being presented the Dean Clarence Manion Award the same year. He was admitted to the Illinois Bar in 1968.

Mr. Sandner formerly was a trial attorney with Lane and Monday, and currently is a member of the American Bar Association, the Illinois Bar Association and the Chicago Bar Association. He has been admitted to practice law before the Supreme Court of the United States, the U.S. Court of Appeals, the U.S. District Court and the Supreme Court of Illinois.

In addition to serving as a CME Governor from 1977 to the present, Mr. Sandner is on the University of Notre Dame Law Advisory Council (1987) and the Board of Directors of the National Futures Association (1982).

Mr. Sandner is married and has six children.

WILLIAM J. BRODSKY
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CHICAGO MERCANTILE EXCHANGE

William J. Brodsky joined the Chicago Mercantile Exchange on September 7, 1982, as Executive Vice President and Chief Operating Officer. On June 1, 1985, he succeeded Clayton Yeutter as President and Chief Executive Officer.

Prior to joining the CME, Mr. Brodsky was with the American Stock Exchange from 1974 to 1982 and held the title of Executive Vice President for Operations between 1979 and 1982. From 1968 to 1974, Mr. Brodsky was an attorney with the New York investment banking and securities brokerage firm of Model, Roland and Company.

Mr. Brodsky received an A.B. degree from Syracuse University in 1965 and a J.D. degree from the Syracuse University College of Law in 1968. He is a member of the bar in New York and Illinois.

At Syracuse University, Mr. Brodsky serves on its Board of Trustees, the Endowment Committee and the Board of Visitors of its College of Law.

Currently, he is a Board Member of the Chicago Council on Foreign Relations, J.L. Kellogg Graduate School of Management Advisory Council, and the Chicago Association of Commerce and Industry, where he is the Vice President for the World Trade Division. He is a member of the Commercial Club of Chicago and the Economic Club of Chicago.

He also serves on the boards of the Japan American Society of Chicago, the Swiss Commodities, Futures and Options Association, and the International Futures and Commodities Institute in Geneva.

ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

Robert K. Wilmouth is president and chief executive officer of National Futures Association (NFA), the industry-wide self-regulatory organization for the futures industry. NFA closely monitors the business and professional activities of its some 3,000 Members and 57,000 Associate Members. NFA performs financial audits, sponsors an arbitration program for the resolution of disputes, and educates its Members and the general public.

Wilmouth took the helm as president of NFA in 1982 when the organization was founded. Before joining NFA, he served for five years as president and chief executive officer of the Chicago Board of Trade.

Wilmouth's 10-year association with the futures industry follows a distinguished 27-year long career in banking.

He is currently the chairman of LaSalle National Bank and serves on the boards of LaSalle National Corporation, Private Export Funding Corporation and the Economic Club of Chicago. He is a member of the Board of Trustees of the University of Notre Dame and chairs its Investment Committee. He also serves on the advisory council of Northwestern University Kellogg Graduate School of Management.

VIII

EXPERT WITNESSES WHO TESTIFIED BEFORE THE SPECIAL COMMITTEE TO REVIEW TRADING PRACTICES

I. FCM REPRESENTATIVES.

Jack A. Barbanel
Senior Vice President
Gruntal & Co., Inc.

John S. Conheeney
Chairman
Merrill Lynch Futures, Inc.

Thomas Dittmer
Chairman
Refco, Inc.

David Ganis
President, Northern Futures Corporation
Chairman, Futures Industry Association

Andrew Harmstone
Vice President
Futures & Options Group
J.P. Morgan Investment Management, Inc.

Philip Hubbard
President
Chicago Research & Trading Services, Inc.

R. Sheldon Johnson
Managing Director
Morgan Stanley & Co., Incorporated

Jack H. Lehman III
Senior Executive Vice President
Shearson Lehman Hutton Inc.

Barry J. Lind
President
Lind-Waldock & Company

Richard Sandor
Vice President
Financial Futures
Drexel Burnham, Lambert Inc.

David Vogel
Chairman
LIT America, Inc.

David Weinberger
Co-Managing Partner
OCA, Inc.

Robert E. Zeliner
President
Barnes Asset Management, Inc.

II. FUTURES INDUSTRY EXPERTS.

Paul Brakke
Chief Trader
Passive Investments
Bankers Trust

Robert G. Easton
President and CEO
Commodities Corporation

Professor James Gammill
School of Business
Harvard University

Frank J. Jones
Director
Barclays Bank

Paul Tudor Jones
Chairman
Tudor Investment Corp.

William P. Miller II
Portfolio Strategist
General Motors Corporation

Hardwick Simmons
Chairman, Private Client Group
Shearson Lehman Hutton Inc.
Chairman, Securities Industry
Association

III. INDUSTRY ATTORNEYS.

Ronald H. Filler
Vedder, Price, Kaufman
& Kammholz

Phillip McBride Johnson
Skadden, Arps, Slate,
Meagher and Flom

John V. Rainbolt
Sole Practitioner

Thomas A. Russo
Cadwalader, Wickersham and Taft

IV. CHICAGO MERCANTILE EXCHANGE FLOOR REPRESENTATIVES.

Timothy Brennan
Floor Trader-Live Cattle

Edward G. Denten
Floor Broker-Live Cattle

Howard Dubnow
Floor Broker-S&P 500
Member, Board of Governors

Mark R. Gordy
Floor Broker-S&P 500

Yra Harris
Floor Trader-Currencies
and Options.

Maury A. Kravitz
Floor Broker
Broker Association Principal

Lewis Lauter
Floor Trader-S&P 500

Martin Liebman
Off-Floor Trader-Japanese Yen

Harry Lowrance
Floor Broker-Japanese Yen

John J. McGuire
Spread Broker
Eurodollars and U.S. Treasury Bills

Randy P. McKay
Off-Floor Trader

William C. Muno
Floor Broker-Pork Bellies
Member, Board of Governors

John L. Oberman
Floor Broker-S&P 500
Broker Association Principal

Gerald E. Pam
Floor Broker-Live Cattle

T. Christopher Phillips
Dual Trader-Deutschemarks

Laurence M. Rosenberg
Floor Trader-Live Cattle
Business Conduct Committee Chairman
Member, Board of Governors

William R. Shepard
Floor and Off-Floor Trader

Edward Toppel
Floor Trader-S&P 500

Steven E. Wollack
Floor and Off-Floor Trader-Currencies
Chairman, Floor Practices Committee
Member, Board of Governors

IX

EXPERTS WHO SUBMITTED WRITTEN TESTIMONY TO OR WHOSE WRITTEN WORK WAS CONSIDERED BY THE SPECIAL COMMITTEE TO REVIEW TRADING PRACTICES

Larry J. Adams
President
Adams & Associates, Inc.

Jack A. Barbanel
Senior Vice President
Gruntal & Co., Inc.

Ralph Berman
Cadwalader, Wickersham and Taft

Glen S. Bromagen
Ashbrook Farm

Jeffrey R. Carter
First Continental Trading, Inc.
Exchange Member

Edward Denten
Exchange Member

James F. Gammill
School of Business
Harvard University

David R. Ganis
President
Northern Futures Corporation

Sanford Grossman
School of Business
Princeton University

Thomas A. Hieronymus
Formerly of the
School of Business
University of Illinois

Phillip McBride Johnson
Skadden, Arps, Slate, Meagher and Flom

Paul Tudor Jones
President
Tudor Investment Corp.

Robert D. Josserand
President
National Cattlemen's Association

Peter F. Karpen
Director
The First Boston Corporation

Arnold Kauffman
Exchange Member

James J. Kaulentis
Managing Partner
ABS Partners
Exchange Member

Maury A. Kravitz
Managing Partner
ABS Partners
Exchange Member

Morton Lane
President
Discount Corporation of New York Futures
Exchange Member

Merton Miller
Graduate School of Business
University of Chicago

Patrick J. Mulchrone
Exchange Member

William C. Muno
Member, Board of Governors
Exchange Member

John V. Rainbolt
Sole Practitioner

Thomas A. Russo
Cadwalader, Wickersham and Taft

William G. Salatich
Exchange Member

Richard L. Sandor
Vice President
Financial Futures
Drexel Burnham, Lambert, Inc.

Louis G. Schwartz
Exchange Member
Chairman, Floor Practices Committee
Member, Board of Governors

Howard J. Siegel
Vice President
Siegel Trading Company
Exchange Member

Lonny Siegel
Exchange Member

Michael Weinberg, Jr.
Exchange Member

Chicago Board of Trade

1988 Disciplinary Case Profile

Trade Practice Inquiries:	1464
Above Inquiries generated by computerized surveillance:	977
Convictions to date based on above:	53
Fines issued to date based on above:	$1,450,000
Suspensions:	17 years
Expulsions:	1

UPDATE

ENHANCEMENTS TO THE CHICAGO BOARD OF TRADE SURVEILLANCE AND COMPLIANCE SYSTEM

The Board of Trade has always prided itself on providing liquid markets with the highest degree of integrity possible. Throughout its 140-year history, the Board of Trade has constantly strived to uphold the integrity of its marketplace. Since the beginning of 1989, the Exchange has taken significant steps to improve the efficiency of its trade practice surveillance systems. Among those steps are the following:

ENHANCEMENTS TO CTR SYSTEM

- One million dollars has been approved to enhance the computerized trade practice surveillance system at the Exchange.
- 100% of daily trading activity is now examined through the CTR Plus system, the Exchange's computerized trade practice surveillance system.
- Significant additional computerized surveillance tests are being programmed.
- Increased data storage capacity, enabling investigators to review trading activity over expanded periods of time, has been implemented.
- A relational database, allowing investigators to relate data quickly over extended periods of time, has been implemented.
- Expert systems technology is being utilized to allow investigators to individually customize programs according to their investigatory needs.

AUDIT TRAIL ENHANCEMENTS

- Time stamp machines in clearing firm floor booths will be synchronized with the Exchange's master clock system, accurate to within 10 seconds (to the nearest second when the technology is available). All customer orders will be time stamped in this manner.
- Time brackets have been reduced from 30 minutes to 15 minutes.
- A starting and ending bracket of five minutes in duration has been created.
- Traders are required to account for all trading cards in sequentially numbered order.

- Members' trading cards will be picked up by clearing firms at one-hour intervals.

- Trading cards will be time-stamped by clearing members when they are picked up from members.

- Clearing firms must submit all trade data to the Clearing Corporation one hour after the information has been collected.

PERSONNEL

- 25 additional employees have been hired in the Office of Investigations and Audits in its 1989 budget, an 30% increase over 1988.

- Attorney staff exclusively supporting the Office of Investigations and Audits has tripled.

- Five computer programmers have been hired to work exclusively on OIA surveillance systems.

- Special training programs in investigative techniques are being conducted for staff of the Office of Investigations and Audits by outside professionals.

TRADE PRACTICE RULES

- The Chicago Board of Trade has commissioned Dr. Sanford J. Grossman, the John L. Weinberg Professor of Economics at Princeton University, to perform a comprehensive empirical study of dual trading.

- A regulation requiring the registration of all broker associations has been established.

- A "modified call" closing rule has been put into effect whereby at the end of the trading day, additional trading activity will be permitted to occur for a period of two minutes. Trades must be made at a price within the closing range and no new orders may enter the pit during this period.

- Floor clerks will be prohibited from holding trading accounts.

- The Board of Directors' fining authority has been increased from $75,000 to $250,000.

ELECTRONIC ENHANCEMENTS

- EOS, an electronic order system, has been developed whereby customers' orders will be electronically routed directly to a broker in the trading pit. Upon execution, the transaction will be electronically reported back to the clearing firm and simultaneously submitted for matching to the Board of Trade Clearing Corporation. As a result, the accuracy of the Exchange's audit trail for customer transactions will be substantially improved.

- In the future, broker workstations are being developed whereby brokers will operate from a computer terminal which will record all customer orders and executions.

- Hand-held terminals are being researched whereby brokers and local traders will enter their transactions for recordkeep- ing, audit trail and clearing purposes into hand-held computer terminals.

- The AURORA System, the Exchange's computerized auction market, is also being actively developed. Aurora attempts to provide the liquidity that is found in the physical open outcry auction market today by means of a computer. Aurora will operate only during those hours when the Board of Trade's physical pits are not open for trading.

For additional copies contact the Chicago Board of Trade
Washington Office, 1455 Pennsylvania Avenue N.W., Suite 1225, Washington, D.C
20004, (202) 783-1190;

or the Chicago Board of Trade,
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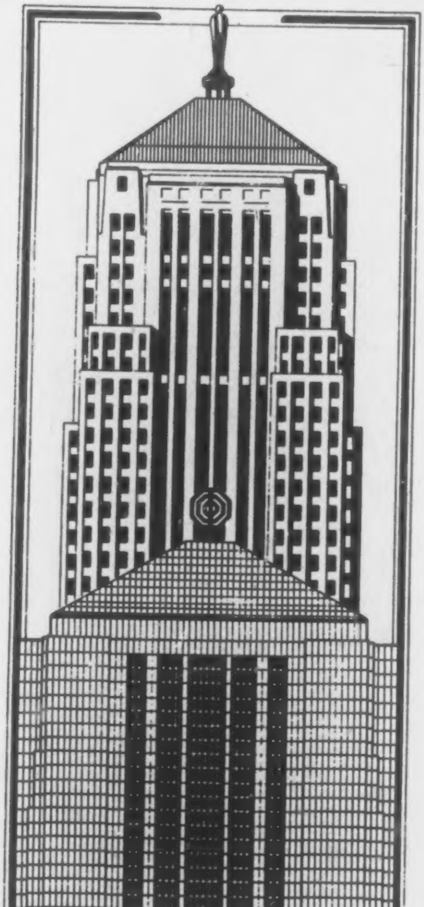
LaSalle at Jackson, Chicago, Illinois 60604
(312) 435-3620.

Supplemental Submission Before the Senate Committee on Agriculture, Nutrition, and Forestry



May 17, 1989

Chicago Board of Trade

TABLE OF CONTENTS

Executive Summary 1
The Exchange. 6
Foreign Competition 8
Oversight and Enforcement 10
The Federal Investigation 15
Approved Market Enhancements. 16
Conclusion. 26

Appendix 1: Foreign Competition Tables
Appendix 2: Broker Trading (CFTC Submission)
Appendix 3: 1987 and 1988 Disciplinary Action Summary

Karsten Mahlmann
Chairman
Board of Trade of the City of Chicago
May 17, 1989
U.S. Senate Committee on Agriculture,
Nutrition and Forestry

EXECUTIVE SUMMARY

The Board of Trade of the City of Chicago is the world's oldest and largest futures exchange, not only because CBOT markets are the most liquid, cost-efficient markets in the world, but also because of the Exchange's committment to the highest degree of market integrity. Professional market user confidence in both the integrity and efficiency of CBOT markets is best demonstrated by the record volume which the Exchange has experienced each year for the last decade.

The Exchange does not now condone, and never has condoned, trading abuses of any kind. Founded on the concept of self-regulation, the Exchange has consistently policed and disciplined its own members. When floor trading abuses are detected and proven, the Exchange has always sanctioned violators appropriately, including the imposition of suspensions, fines and expulsions. The Exchange's commitment to preserving the utmost market integrity is undiminished today.

The cornerstone of market integrity is membership integrity. The Board of Trade has always maintained the highest standards of member qualification. As United States Attorney Anton Valukus recently asserted, "the best experts in the world concerning trading practices are the members of the Board of Trade."

Additionally, the Department of Investigations & Audit's ("OIA") use of Computerized Trade Reconstruction system ("CTR") is a vital means of detecting rule violations thereby insuring market integrity. CTR is universally acknowledged to be the best audit trail in any of the world's financial marketplaces. Similarly, CTR-PLUS, the Exchange's surveillance system, is an unsurpassed system for the detection of potential market abuses. Indeed, the CTR-PLUS system highlighted as a potential abuse the trading activity of an apparent FBI agent trading as a member at the exchange, presumably pursuant to a federal investigation. As U.S. Attorney Valukus has acknowledged, the Board of Trade has "... the resources to identify trading practices in which fraud has occurred."

Regardless of this unparelleled record of success, the Exchange has consistently recognized that improving markets and surveillance systems is an ongoing and never-ending task. The Exchange is constantly examining its market mechanisms and surveillance techniques to insure that it remains the world leader in this regard. This self examination process has intensified in recent months in the wake of the sensationalized press reports of FBI and United States Attorney investigations into alleged trading floor abuses at the Chicago Mercantile Exchange and the Board of Trade.

While no confirmation of any trading abuses has yet been offered, no indictments issued, and no convictions obtained, the Exchange has nevertheless recognized that continued public confidence in the marketplace requires an intensive review of market mechanisms as well as the surveillance and disciplinary processes. For the past several months, special exchange committees have engaged in detailed reviews and examinations of the Exchange's market structure and enforcement mechanisms.

The Board of Trade remains committed to preserving the liquidity, efficiency and integrity of its markets. That commitment will continue regardless of whether the current investigation ultimately results in any convictions or none whatsoever. Thus, the Board of Directors has approved (not merely proposed) numerous revisions in our market mechanisms and enforcement procedures.

Broker Trading (Dual Trading)

Permitting floor brokers in the futures industry to trade for their own account while also executing customer orders recently has been questioned. Despite the fact that there have been no indications that any federal investigation is concerned with any aspect of broker trading, and despite the fact that the CTR-PLUS system is specifically programmed to detect (*inter alia*) any broker trading ahead of a customer's order, a few have questioned whether this practice is in the best interest of the marketplace.

Initially, broker trading is not unique to futures markets. Trading for one's own account while handling customer orders is a common practice in all financial markets; specialists and securities firms universally trade for their own account while executing customer orders.

Congress, the CFTC and the futures industry have studied broker trading many times in the past decades. In each instance, the results overwhelmingly indicate that the ability of floor brokers to provide additional liquidity to the market by trading for their personal accounts is a valuable and necessary part of the marketplace. Preliminary Exchange data indicates that broker trading provides from 25-80% of futures market liquidity at the CBOT. The Exchange strongly believes that any potential abuses of dual trading can be and are detected by current surveillance systems. Therefore, the Exchange feels that the elimination of broker trading would seriously impair market liquidity while serving no useful market purpose.

However, the Exchange recognizes that concerns exist. Thus, the Board has retained the services of Dr. Sanford J. Grossman, the John L. Weinberg Professor of Economics at Princeton University, to make a comprehensive empirical study of broker trading in today's futures markets. This study, along with those conducted in the past and that conducted by the Exchange staff, will form the basis of further evaluation of the value of broker trading to the nation's futures markets.

The Board of Trade strongly urges this Committee to evaluate these studies in their entirety, as well as additional studies which may be submitted to the Committee, before making any final deliberations on this vital issue. The liquidity of the world's most efficient futures markets is at stake. The continued preeminence of United States futures markets deserves careful, considered study before any final recommendations for action.

Exchange Surveillance Systems

As a result of the recent extensive reviews by select Committees, the Exchange has instituted numerous enhancements to the CTR and CTR-PLUS systems. The following enhancements and improvements have been approved:

1) The CTR-PLUS surveillance program has been expanded to analyze every trade made on the Exchange, rather than statistically selected samples.

2) A one million dollar fund for the further improvement of the CTR and CTR-Plus systems has been authorized.

3) Trade time recordation brackets have been reduced from thirty (30) minutes to fifteen (15) minutes.

4) New five (5) minute time brackets have been approved for the opening and closing periods of trade when trading generally is heaviest.

5) The Exchange has enhanced trading card recordation requirements to now require that all trade cards must be accounted for; all trading cards be collected and time-stamped hourly; and all trades submitted to the Clearing House within one hour of collection.

6) CTR-PLUS has been improved further by providing expanded surveillance tests, an expanded relational data base, and increased storage capacity.

7) The Exchange has required that all trading floor time stamp clocks be synchronized and accurate to within ten second intervals.

8) Additionally, five new computer programmers have been hired to support an extensive member/staff review and revision process of all surveillance systems.

Office of Investigation and Audits Enhancements

The Office of Investigations and Audits ("OIA"), the second largest department at the Exchange, has always maintained the highest level of professionalism and excellence. The high degree of professionalism exhibited by OIA has prompted U.S. Attorney Valukus to remark "I have a great deal of confidence in the staff of the Board of Trade." To further strengthen OIA, the Exchange has recommended further enhancements. These include:

9) OIA professional personnel will be expanded by thirty percent (30%) over 1988 levels;

10) The attorney staff exclusively supporting OIA efforts has been increased threefold.

11) Special training programs in investigative techniques conducted by professional consultants have been approved and instituted for OIA staff.

12) An increased presence of OIA investigators on the trading floor has been approved.

Board of Directors Policies

The Exchange has reexamined the powers, authorities and structure of its Board of Directors. The Exchange Board is currently a diversified body consisting of representatives from all aspects of the industry as well as public directors. The Rules of the Exchange and the diverse structure of the membership insure that such broad representation will continue to exist. To enhance the function of the Directors, the Board has approved the following enhancements:

13) The Board has approved and submitted for membership approval increasing the fining authority of the Board of Directors by more than three hundred percent (300%) from seventy-five thousand dollars ($75,000) per violation to two hundred fifty thousand dollars ($250,000) per violation.

14) The Board of Directors has formally reaffirmed its long-standing policy of excluding members with a history of significant trade practice sanctions from being on the Board of Directors and major exchange disciplinary committees.

Floor Practices

The Exchange has intensively reviewed existing policies, rules, regulations and practices governing floor trading. The Exchange believes that its rules and policies are highly refined to preserve both the utmost integrity and market efficiency. Nevertheless, the following enhancements have been made:

15) Broker associations generally do not exist at the Board of Trade. Nevertheless, to prevent abusive associations from evolving, the Exchange has adopted a rule requiring that any association of floor brokers must register with the Exchange in order to enhance the Exchange's surveillance of their trading activities.

16) The Exchange has approved and submitted to the CFTC for its approval a rule establishing a modified closing call period at the conclusion of trading to better

facilitate orderly execution of closing orders and increase the efficiency of price discovery during closing market periods. This rule includes separate identification of this modified closing call period for CTR-PLUS surveillance purposes.

17) The Exchange has prohibited floor clerks from maintaining trading accounts.

The Exchange also has done extensive work in two other areas which will enhance the Exchange's audit trail and, therefore, its surveillance capability. For many months, the Exchange has been developing an electronic order-entry system ("EOS") which will speed public orders directly to the pit via computerized entry; the resulting order record will be accurate to the second and will greatly enhance surveillance as well as better serve public customers.

Additionally, the Exchange has under review the development of a hand-held trade entry device for use by members on the floor to record electronically all their trades and instantly transmit the trades for clearing. Although the technology for such a device is not presently available, the Exchange has committed significant resources to the development of a hand-held trade terminal which will accurately record trade execution to the second.

The Board of Trade believes these improvements and others still under study will insure that its markets remain the world's most efficient, liquid and economical while simultaneously preserving the highest degree of integrity and professional participation. This is a goal which we believe that all of us - futures exchanges, the CFTC, Congress and market participants - share equally. Other Exchanges (which have different markets, trade other products, have separate memberships and, in many cases, different market users) may have distinct needs with respect to enhancements of their existing systems. We strongly urge this Committee to consider these differences in its consideration of any legislative action.

We believe that if the Committee does so, it will conclude that any regulation of the marketplace is best accomplished in a "management by objective" fashion. For example, when Congress and the CFTC mandated improvements to the audit trail in 1986, that mandate provided that each Exchange should meet a common goal by whatever means is best suited to its markets. Thus, the Board of Trade responded by developing CTR. So too, in any current requirements for market enhancements and improvements, Congress and the CFTC should similarly establish broad objectives which the self regulatory organizations are obligated to meet, but in the manner which they choose to best serve their particular marketplace.

The end result of such an approach after careful study will undoubtedly be the improvement of our existing efficient, liquid and honest futures markets. The danger of failing to achieve this goal is that our current markets could easily be exported to foreign nations who are eagerly establishing new futures markets hoping to capture what is now a uniquely American industry.

THE EXCHANGE

The Board of Trade of the City of Chicago is the world's oldest and largest futures exchange. Founded in 1848, the Exchange currently is designated by the Commodity Futures Trading Commission ("CFTC") as a contract market for fifty eight (58) futures and futures options products, twenty six (26) of which are actively trading; these include grains, financial futures and precious metals. Four of the world's top ten contracts (by 1988 volume) are traded at the Board of Trade: United States Treasury Bond Futures; Options on U.S. Treasury Bond Futures; Soybean Futures; and Corn Futures. In 1988, the Exchange traded 143 million contracts, nearly twice that of the next largest domestic futures exchange and more than the next four domestic exchanges combined.

The Exchange strongly believes that the prevention of potential market abuses begins with the integrity of the membership itself. Innumerable member, staff and outside professional investigation hours are expended on each application to insure that the utmost member integrity is attained. In 1988, eight hundred twenty (820) applications for membership were processed by the Exchange. Members must trade (i.e. contract with) other members in the trading pits; the members therefore demand that admission to membership be a determination of individual integrity which ensures fair, honest and equitable dealing among members.

The Exchange membership consists of 1402 Full Members and an approximately equal number of Associate membership and membership interest holders. The membership is a diverse mix of individual ("local") traders, brokers, and member firms including futures commission merchants ("FCMs"), commercial firms, investment banks and other professional market participants.

All members are required by Rule to be "... of good character, reputation, financial responsibility and credit ..." as determined in the first instance by the Membership Committee and approved by the Board of Directors. Those wishing to be licensed floor brokers handling customer orders must also undergo additional investigation through the National Futures Association which includes an FBI fingerprint check.

Applicants are required to submit extensive background information which is subject to independent, professional verification. Applicants must also obtain the sponsorship of two existing members; on some occasions, sponsorship may entail a financial guarantee. The admission process includes at least one personal interview before the Membership Committee. Applicants are then recommended to the Board of Directors for approval or disapproval. Those applicants recommended for disapproval are given the opportunity for a hearing. Disapproved applicants may appeal that action to the CFTC.

This rigorous membership approval process helps assure the fair dealing among members which forms the cornerstone of self-regulation. As commonly recognized, self-regulation does include the ability to promulgate and enforce one's own rules and regulations. Indeed, in 1988, the Exchange made seven hundred fifty-nine (759) rule and regulation revisions. Additionally, in 1988 cases, the Exchange issued charges for trade rule violations in fifty-three (53) instances resulting in a total of seventeen (17) years of suspensions and $1,450,000 in fines.

But self-regulation means more than rule promulgation and enforcement. It also means that members are not going to stand for being treated unfairly or dishonestly by their fellow members. Most trading floor abuses involve a trading opportunity withheld from the entire trading arena. Fellow member-traders are not going to condone or tolerate a lost trading opportunity. Indeed, the majority of Exchange disciplinary actions resulting in significant sanctions began with a complaint from a member regarding another member's conduct.

This is the essence of self-regulation: membership integrity upon admission coupled with the vested interest to preserve that integrity on the trading floor. It is by strict adherence to these principals that the potential for trading abuses is minimized even prior to surveillance, detection, enforcement and sanction. This is a principal reason market users have such confidence in Board of Trade markets. Indeed, in 1988, public market users made only thirty five (35) complaints to the Exchange regarding potential trade practice abuses; considering the one hundred forty three million (143,000,000) contracts traded, this is a remarkably small percentage of complaints.

Nor is confidence in the integrity of Board of Trade markets, oversight and enforcement limited to professional market users. It is also shared by top law enforcement officials who have experienced through representation of clients at CBOT disciplinary hearings the thoroughness and efficiency of Exchange rule enforcement.

> One of the things we do keep track of is what's taking place at the Board of Trade. We are interested in the proceedings at the Board of Trade. We're interested because, in my estimation based on my own expertise in the area, the best experts in the world concerning trading practices are the members of the Board of Trade. I have a great deal of confidence in the staff of the Board of Trade. They are able to ask the difficult questions; they have the resources to identify trading practices in which fraud has occurred. And frequently, in my experience, when they are holding their hearing, they are able to get to the tough questions quickly. And since the individuals that are subject to these proceedings are subject to examination, they ask those questions, get responses and those responses are on the record.

* * *

> We often in these cases call upon the Board to make an evaluation of members from the Board, individuals from the Board, in helping us to find whether or not there is a fraud involved. That is to say that we rely on their expertise. [Emphasis added.] Remarks of Anton R. Valukas, United States Attorney for the Northern District of Illinois, Kent Commodities Law Institute, Workshop on Enforcement/Criminal Matters, October 21, 1988.

It is this combination of innovative, efficient, liquid markets and a reputation among professional market users for unsurpassed integrity which is largely responsible for the Board of Trade's preeminent position in the world's futures markets. However, that preeminence is fragile. Competition for new markets among domestic exchanges, always fierce, has intensified. But more critically, the challenge of foreign competition for dominance in futures trading is increasing daily.

FOREIGN COMPETITION

The efficiency and liquidity of United States futures markets are the envy of the entire world. Virtually every major nation on earth - Japan, Great Britain, France, Switzerland, Australia and even China - has established futures markets in the image of Chicago's futures markets. These foreign futures markets in many instances are directly subsidized by the national government and are strongly supported by national mandate. There is no secret to futures contract specifications; they can be imitated by photocopy in minutes. It is the experience, expertise and integrity of the floor trading population which establishes Chicago's futures markets as the world leader. But, that market edge is fragile and could be easily upset or destroyed.

The foreign challenge to the U.S. futures industry has increased markedly in recent years. Although activity at U.S. futures exchanges has continued to grow, activity at foreign exchanges has grown much faster. The market share of U.S. exchanges has declined because futures exchanges have proliferated overseas; products offered by foreign exchanges have become more diverse as the benefits of futures markets become better understood. Foreign exchanges now compete directly with American exchanges; there are now several contracts traded on foreign exchanges which are identical to contracts traded domestically.

The statistics are sobering, if not frightening.

In the past four years, the Board of Trade has increased its total volume of contracts traded by 91%. However, during that same period, the Exchange's market share of world-wide futures volume decreased by 3.6 percent (from 37.6% of the world market to 34%). The reason the Exchange lost world market share was that foreign exchange volume grew 226%. (*See* Appendix 1, Figure 1.)

In 1985, the ten most actively traded futures contracts in the world were all United States products. By 1986, the fifth most actively traded contract was Japanese, a position which it continues to hold today. By 1987, the seventh most actively traded contract was French; today, the French Bond Futures contract has grown to occupy the number six position on the list. (See Appendix 1, Table 3.) In 1985, no foreign futures contracts were among the twenty-five most actively traded. Today, six of the top twenty-five are foreign contracts. (See Appendix 1, Table 4.)

From 1984 to 1988, domestic futures trading grew 35%. But foreign futures trading grew by 84% in that same period. (See Appendix 1, Table 2.) The London International Financial Futures Exchange ("LIFFE") trades a U.S. Treasury Bond Futures contract identical to the Board of Trade's most actively-traded contract. Volume in the LIFFE U.S. T-bond contract has tripled since 1985 to over two million contracts per year.

Statistics prove that market users are willing and able to quickly shift their market activity overseas. For example, U.S. Treasury Bond futures trading was brisk following the October 19, 1987 stock market break. On Tuesday, October 20, prices of the Board of Trade's Bond futures contract increased up to the upper limit allowed for a single day; as required by Exchange rules, trading in T-bond futures was effectively stopped. As a result, less than 35,000 T-bond contracts were traded during daytime trading at the CBOT on October 20 compared to the daily average volume of 286,505 during October, 1987. Instead, market users shifted their activity overseas to the LIFFE when their needs could not be met in the U.S. Volume in the LIFFE T-bond contract exploded to over 47,000 contracts traded on October 20, nearly eight times its average daily volume of 6,200 for the first ten months of 1987. (See Appendix 1, Table 6.) The increase in volume at the LIFFE might have been even greater had market users been more familiar with that exchange and had they not had such a strong preference for the CBOT margin and clearing system.

Despite the well-known integrity and liquidity of the CBOT T-bond contract, participants in the T-bond market sought risk management services elsewhere once trading in the CBOT market stopped. This event demonstrates the ease of shifting futures market activity abroad if necessary. Thus, even the world's most active futures contract is vulnerable to foreign competition.

It is clear that there are now numerous risk management vehicles available to those who need to hedge against price risk and to speculators who are willing to accept that risk. American futures markets compete not only with foreign futures exchanges, but also with alternative risk management vehicles such as forward contracts, swaps, caps, collars and other financial products. These various risk management products are available at the touch of a telephone button; global markets are all easily accessed and are becoming more familiar to market users.

The availability of so many other methods and locations to conduct risk management means that any increase in the costs of using one of these vehicles can result in a huge disadvantage relative to the competition. This high degree of competition means that market users benefit as each provider must keep its costs low, and the quality of customer service must be maintained in order to keep customers. On the other hand, any regulations that increase the cost of using futures markets or reduce the quality of customer service being provided will put the U.S. futures industry at a competitive disadvantage. To choose but one instance, restrictions on broker trading would reduce the efficiency of U.S. futures markets and would lower the quality of service provided to users of these markets. (It should be noted that broker trading is not banned in foreigh markets.)

In the face of such intense, dedicated international competition for what are now uniquely American markets, Congress must carefully consider its actions to avoid any action which could cripple domestic futures markets. Even those foreign markets which stand to benefit from any hasty U.S. legislative reaction have expressly cautioned us not to enact ill-considered legislation.

> America's politicians would therefore be well advised to temper their natural desire to "do something" and refrain from hasty ill-considered regulation of Chicago. That "casino", as it is described by its opponents, is in fact one of America's most successful industries.... Toyko and London, not to mention other financial centres, would clearly love to get a bigger slice and will seize any opportunity to do so. It was, it needs to be remembered, ill-considered American legislation in the 1960's that allowed London to become the centre of the international debt markets, usually known as the Euromarkets. Future Permanent, The Economist, June 11, 1988.

Today, we have the best futures markets in the world, reputed for both their cost efficiency and market integrity. We must carefully preserve that delicate balance in the face of our less regulated foreign competition as we consider any proposals for regulatory change. We must not deceive ourselves into thinking that our foreign competitors will not create a quality product at the lowest price possible. The proof is self-evident; they have done so in countless other industries where the United States was only recently the world leader.

OVERSIGHT & ENFORCEMENT

Competition for market share is not dependent solely on market liquidity and efficiency. Market users value the integrity of the trading process very highly. While strict member admission standards and vested self-interest form the foundation of market integrity, vigorous oversight, surveillance and enforcement are also of paramount importance. As a membership self-regulatory organization, the Board of Trade insures compliance with fair and equitable trade practices principally through three committees: the Floor Governors Committee; the Business Conduct Committee and the Board of Directors.

The duties and powers of the Floor Governors Committee are generally defined by CBOT Rule 543.00 which provides that the Committee shall assure that the practices and conduct of members of the Association, member firms and other persons with trading privileges on the Exchange Floor are in compliance with the Rules and Regulations of the Association. The Committee is authorized to take action against persons and firms including: (1) dismiss charges and close the matter; (2) issue a warning letter; or (3) issue preliminary charges and schedule a hearing on the merits. If preliminary charges are issued, the Committee will afford the respondent(s) opportunity for a formal, evidentiary hearing of record with right to counsel. If, after hearing, the Committee determines rule violations have occurred, the Committee may fine or suspend the respondent or may charge the respondent and refer the matter to the Board for the imposition of sanctions.

Additionally, Regulation 540.09 provides respondents with the opportunity and means to settle preliminary charges. Settlements may be accepted on such terms and conditions as the Committee may deem appropriate.

The duties and powers of the Business Conduct Committee are generally defined in CBOT Rule 542.00 which provides that the Committee is responsible for preventing price manipulation and the cornering of any commodity on the Exchange and for supervising the business conduct of all members, member firms and other persons with trading privileges. In regard to the latter responsibility, two of the duties of the Committee are (1) to enforce the minimum capital rules of the Exchange, as approved by the CFTC; and (2) to enforce Exchange Rules and Regulations pertaining to the handling of customer orders, customer accounts and margins. Other duties include reviewing requests from firms to pre-pay subordinated loans, supervision of firms that are regular for delivery on Board of Trade agricultural contracts, and all general matters of member solvency.

The Committee is authorized to impose specific disciplinary sanctions; to recommend that the Chairman impose restrictions on the operations of a member, member firm or other person with trading privileges; and to impose restrictions on member FCMs that fail to meet the capital requirements of the Exchange. The Committee also is authorized to order any member to cease and desist from past or proposed conduct that it finds, after notice and an opportunity for hearing, to be unfair, unjust or in violation of CBOT Rules and Regulations. The Committee may impose a fine of up to twenty five thousand dollars ($25,000) for each violation. Cease and Desist Orders are final and not appealable. As an alternative to issuing a Cease and Desist Order and/or a fine in disciplinary matters, the Committee may file charges against a member, member firm or other person with trading privileges with the Board of Directors.

Decisions of both the Floor Governors Committee and Business Conduct Committee generally are appealable to the Board of Directors. The Committees may also refer charges to the Board for its disposition where the Committee feels its sanctioning authority is too limited for the severity of the violations found. Thus, the Board functions in the one instance as a pure "appellate" body, and in the other purely as a sentencing forum. In either instance, a general right of appeal from a Board decision to the CFTC is provided by Part Eight of CFTC Regulations.

Member disciplinary committees are uniquely qualified to enforce Exchange rules. The knowledge of trade practices and experience with the business of futures trading possessed by these members cannot be duplicated outside the Exchange. Members of the Floor Governors Committee and Business Conduct Committee typically have ten to twenty years experience in futures trading, most of it at the Exchange. This member expertise is an invaluable and irreplaceable asset in the oversight and enforcement of Exchange rules.

Equally valuable as member expertise is the professional staff support the Committees receive. The Board of Trade continually monitors member and member firm compliance with its rules and regulations, as well as those of the industry, through its Office of Investigations and Audits. As part of its surveillance efforts, the OIA is constantly in contact with other Exchanges, the National Futures Association and the CFTC to exchange relevant information.

OIA is comprised of five interrelated departments. The Investigations Department is responsible for investigating inquiries from customers and referrals from members, member firms and the CFTC concerning any market activity or trade practices which involve potential violations of Board of Trade rules and regulations. These investigations involve a comprehensive process of obtaining statements from witnesses and parties involved, conducting trade reconstruction reviews and analyzing trading documents. The department may close cases administratively when there is insufficient evidence of rule violations. All cases involving potential rule violations are submitted to the appropriate Exchange disciplinary committees. The department is responsible for the preparation and prosecution of cases involving its investigations.

Staff of the Investigations Department is also responsible for initiating and conducting Trade Practice Investigations ("TPIs") on a continuous basis. TPIs involve reviewing daily exception reports of the Exchange's trading activities of members and member firms to detect patterns of conduct which may indicate rule violations. TPIs are conducted utilizing the Computerized Trade Reconstruction System.

The Investigations Department also maintains a floor surveillance program that involves directly observing floor trading activity on a daily basis.

The Reporting and Research Department is responsible for auditing the Board of Trade's CTR system. It also conducts surprise on-site reviews of all audit trail data submitted by members and member firms. The department is also responsible for maintaining OIA's other various computer systems and coordinating the department's interaction with the CFTC.

The Market Surveillance Department ensures the orderly expiration of all Board of Trade contracts and monitors trading activity in order to detect attempts at price manipulation, squeezes of a commodity or corners in a market. To accomplish these tasks, Market Surveillance compiles and reviews information relating to volume, open interest, current cash commodity prices, available stocks, deliverable supply, and positions held by clearing member firms and large traders. Market Surveillance's analysis of this information identifies futures/cash price relationships which may potentially be disruptive to the marketplace. Statistical reports including historical market data are also compiled weekly.

During a month in which a futures contract is eligible for delivery or expires, Market Surveillance may be in frequent contact with major participants. With respect to stock index futures contracts, Market Surveillance communicates with members of an intermarket surveillance group that includes staff from the New York Stock Exchange, the American Stock Exchange, the Chicago Mercantile Exchange, the Chicago Board Options Exchange, the Philadelphia Stock Exchange and the Kansas City Board of Trade.

The OIA's Financial Surveillance Department ensures that all Board of Trade member firms comply with the Exchange's capital rules and capital guidelines.

The Financial Surveillance Department routinely analyzes the financial health of member firms with the Simulated Analysis and Financial Exposure ("SAFE") system, the most sophisticated computerized financial surveillance program in the futures or securities industries. The SAFE system evaluates the risk of member firms at current market levels and at a variety of combinations of different market and volatility levels. The SAFE system generates approximately one hundred different reports, including but not limited to pay/collect information[*], margin data, and large trader reports. The OIA shares use of the SAFE system with the Board of Trade Clearing Corporation, which developed the system.

Any actual or potential problems discovered during the analysis results in an immediate phone call to the firm or an on-site financial review. Member firms are also required by the Board of Trade regulations to notify the Financial Surveillance Department of changes in key financial data.

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[*] The SAFE system currently reports this information for all U.S. futures exchanges.

The OIA Audits Department conducts biennial reviews of the books and records of each Board of Trade member firm that is registered as a Futures Commission Merchant ("FCMs") to determine compliance with Exchange rules and regulations. Audits focus on the firms' financial and compliance procedures. During a financial audit, a firm's financial condition is analyzed, along with the composition of balance sheets and capital computations to verify that the firm has appropriate procedures to ensure the continuous submission of accurate financial information to the Exchange. Also, customer balances are reviewed and the proper segregation of customer funds is verified.

The compliance portion of the audit examines a member firm's procedures for customer order preparation and processing margins, opening an account, account documentation and discretionary accounts. Cash transactions are reviewed to establish that the firm is properly accounting for customer transactions. The Audits Department also makes surprise sales practice reviews of member FCMs' branch offices and guaranteed introducing brokers. These reviews cover the solicitation of customer accounts and customer complaints.

One of the principal tools used by OIA to conduct its market surveillance and investigation responsibilities is the Computerized Trade Reconstruction System and its derivative system, CTR-Plus. CTR is the world's most sophisticated market audit trail. CTR documents who traded what quantity of which contracts at what price and the time of execution to the nearest second. Critically, CTR data is available within twenty-four hours. Created by the Exchange in 1986, CTR exceeds CFTC one minute time recordation requirements; CTR also eliminates the possibility of individual human manipulation of times without impairing market liquidity as would occur by requiring traders to mark execution times. CTR is the software marriage of two independent computerized trade records, the clearing trade settlement record and the price reporting time and sales journal. By eliminating reliance upon human recording of times, CTR enhances reliability of the audit trail data.

CTR-Plus is comprised of the computerized programs designed by OIA staff, member committees and outside professional consultants to monitor trade activity via computer. Although it previously relied upon statistically valid trade samples, CTR-Plus now reviews 100% of the Exchange's trading activity with a variety of sophisticated surveillance programs. These programs monitor for potential abuses such as trading ahead of customer orders, crossing orders, taking the opposite side of a customer order, prearranged trading, ring trading, wash sales and other similar potential violations of Exchange and CFTC trade regulations.

Simply stated, CTR is the world's best audit trail and CTR-Plus the world's most sophisticated trade surveillance program. Nevertheless, the Board of Trade recognizes that success is a journey, not a destination. Improvements are always possible.

Therefore, an Exchange select oversight committee has been intensively reviewing CTR and CTR-Plus to improve their accuracy and effectiveness. Those enhancements adopted to date are specified hereafter.

THE FEDERAL INVESTIGATION

This Committee is well aware that the Chicago Mercantile Exchange and the Board of Trade have been the subject of widespread media speculation regarding a United States Attorney/Federal Bureau of Investigation ("FBI") investigation on the trading floor of both exchanges. Recent press reports also indicate that a CFTC (and possibly a federal grand jury) investigation is being conducted regarding trading activities at several New York futures exchanges. Unsubstantiated press rumors of alleged fraud at the exchanges have lead some to raise concerns regarding the integrity of the Exchange's markets.

Initially, the Board of Trade does not condone - and never has condoned - fraud or any other trade practice abuse. The Exchange has consistently charged and sanctioned rule violators with penalties ranging from fines to suspensions and expulsions. We have developed CTR and CTR-PLUS as part of our commitment to the goal of ensuring fair and honest markets on which the public and members alike can rely. Should any federal investigation result in proven cases of fraud, we endorse and support the elimination of dishonest traders from the markets. But, at this preliminary stage, we must remember several critical facts.

First, there have been no indictments, merely subpoenas. A subpoena does not establish guilt or even a presumption of a problem, especially broad "record-retention" subpoenas of the kind issued in this investigation.

Similarly, without indictments, there obviously has been no trial, plea or conviction upon which to assess the nature and severity of rule violations, if any. Discussions of any specific rule violation, especially unsubstantiated alleged abuses of broker trading, are purely speculative at this point. At this point, reports of any abuses reside solely in self-serving, sensationalist press articles.

Thus, one should not lose sight of what is known. What is known is that the United States Attorney has assured the Board of Trade that the Exchange itself is not the target of any investigation. What is also of record is the thoroughness and stringency of Exchange member admission policies and practices. What is established is the excellence of the Board of Trade's CTR-Plus system, a system which identified prior to subpoenas being issued the suspicious trading practices of an FBI "mole" trading as a member. Most importantly, what is evidenced by the market enhancements detailed below is the uncompromising dedication of the Board of Trade to improving its already excellent oversight and enforcement programs.

APPROVED MARKET ENHANCEMENTS

There can be no doubt that the history of the Board of Trade to this day is a unique and enviable story of success. From pioneering fair, liquid, efficient agricultural futures in theprevious century to the introduction of financial futures, the creation of trading options on equity securities and the growth of the world's largest futures contracts, the Board of Trade has an unsurpassed record of achievement.

Nevertheless, the Board of Trade recognizes that innovation and improvement are on-going, evolving efforts, not merely an excuse to point with pride to past achievements. The Exchange is constantly examining its market mechanisms and surveillance techniques to insure the continued success and user confidence in our markets.

In recent months, the spotlight cast by the press revelations of a grand jury investigation intensified the Board of Trade's existing evolutionary development of market mechanism refinements and surveillance system improvements. While self-regulation and self-interest alone would require such examination, the potential for lost public confidence in the integrity of these markets demanded a redoubled effort. Consequently, numerous Exchange committees were delegated the task of a thorough review and examination of numerous issues including trade practices, trade rules, CTR and CTR-Plus refinements and membership qualifications.

That review process has culminated in twenty one (21) major recommendations which have been approved by the Board of Directors for implementation. The Exchange's Board of Directors and membership believe this program of enhancements to existing rules and systems will make significant substantive improvements to the already efficient functioning of our markets as well as help to insure that degree of public confidence necessary for the markets to function effectively. A brief description of each action follows.

Broker (Dual) Trading

It is curious and disturbing that although there has been no hint of abuses by brokers trading for their own account while executing customer orders even in the sensationalist press accounts of the grand jury investigation, those who have long misunderstood the role and value of broker trading have chosen to use this as an "opportunity" to resurrect their objections and misconceptions. Thus, it appears that Congress must once again study and evaluate the function that broker trading performs in the markets.

The practice of broker trading, or trading as a principal and as an agent, is widespread in the United States and abroad. For example, broker dealers as well as FCM's trade for the firm's proprietary account while handling customer orders. Securities specialists are not only permitted, but in some instances obligated, to trade for their own account while simultaneously executing customer orders. Thus, any examination of floor broker trading in futures contracts also should require review of the identical phenomena in the structure of FCMs, broker dealers, securities specialists and others.

Broker trading provides two principal benefits to the futures markets. First, because broker traders are permitted to trade for their own accounts, they are able to engage in trading strategies in the course of executing a customer order which result in a better price for the customer than can be obtained by a broker who does not trade for himself. The Exchange's preliminary staff study of broker trading (attached hereto as Appendix 2) provides detailed examples of these trading strategies, describes the specific advantages customers derive from broker trading and presents letters from customers explaining why they prefer to have their orders executed by broker traders.

This element of preference raises the obvious but seldom articulated fact that customers can choose to have their orders executed only by brokers who do not trade for their own account if broker trading is an issue for them. Since most futures market users are commercials or large institutional investors, their ability to so choose is virtually unquestioned. Interestingly, as the letters incorporated herein (at Appendix 2) demonstrate, many such users prefer brokers who trade for their account to execute their orders.

The second principal benefit of broker trading is that it adds substantial liquidity to the market. The Exchange's preliminary analysis shows that between 25% and 80% of the risk capital available in the markets analyzed is provided by broker traders.[1] Because broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets and more capital; this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity is provided by broker traders (for the benefit of all market users), presents further statistics describing the extent of broker trading activity, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

Broker trading is particularly valuable to the Board of Trade because of the nature of our markets. Extensive spreading activity has characterized the contracts at the Exchange, which together with broker trading has been a key part of these particular markets and has helped them become the most efficient in the world. The price relationships among the delivery months in the grains contracts, for example, are the basis for hedging long term storage costs, an application of spreading which is an integral part of the U.S. agricultural industry. Likewise, the cost of carrying government securities can be hedged through spreading in contracts such as Treasury Bond futures at the Exchanges. The role of broker traders is particularly critical in facilitating inter- and intra-market spreading, thus distributing liquidity across commodities and delivery months and forcing bid/ask spreads (customer costs) as low as possible.

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[1] The study notes the Exchange's objections to the definitions which the CFTC required the Exchanges to use for purposes of the data analysis. Therefore, more analysis is necessary to verify the accuracy of the data as requested by the CFTC.

In addressing concerns that potential trading abuses may be associated with broker trading, we must carefully differentiate between the valuable practice of broker trading and the potential trading abuses which may use that practice as a vehicle. By analogy, the practice of check writing is occasionally abused by some who draft fraudulent checks. Restricting or prohibiting check writing would not address the abuses, but it would destroy a valuable, legitimate economic activity. Ensuring that a sound means of detecting abuses is in place and that a stringent set of sanctions has been defined and is applied as appropriate is a more direct and logical approach to dealing with trading abuses than the restrictions or prohibitions of broker trading which some have proposed. Importantly, this approach would not damage market performance as a broker trading curb would.

It is critical to keep in mind that the Exchange's CTR-Plus system enables OIA to easily pinpoint any instances of abuse. Additionally, enhancements which have been made recently and which are planned in this system will only insure greater deterrence to potential abuses, especially given the severe penalties which are applied if such trading abuses are detected. This self-regulatory system which combines ease of detection with strict penalties provides an effective deterrent of potential abuses which may be associated with broker trading at the Exchanges.

However confident the Board of Trade is regarding the value of broker trading and the ability to detect and punish potential abuses, we recognize that the public debate generated concerning the subject requires careful, professional analysis. For that reason, the Exchange has retained Dr. Sanford Grossman, the John L. Weinberg Professor of Economics at Princeton University, to complete a detailed, empirical study of broker trading. Dr. Grossman is a world-renowned market expert who, among other recent duties, was a primary contributor to the report of former U.S. Attorney General Nicholas de B Katzenbach to the New York Stock Exchange following the October 1987 stock market crash. Dr. Grossman's preliminary findings are expected within the next several months; detailed empirical analysis and a final report are currently scheduled to be completed within eight to twelve months thereafter.

With expert analysis such as that provided by Dr. Grossman, Congress will be able to assess better the true value of broker trading to our vibrant but fragile futures markets. Armed with such background, we should all be in a position to determine what modification, if any, is necessary. In so doing, we must also carefully evaluate the differences of different markets.

Trade patterns and practices vary widely from exchange to exchange and even within different markets on each exchange. Therefore, only through "management by objective" - the setting of ultimate goals to be achieved by a variety of means - can regulation in this critical area function without risking irreversible damage to the markets. Since we all share the common objective of honest, liquid, efficient futures markets, the Exchange is confident that a management-by-objective regulatory approach for broker trading will work as well as in 1986 when the CFTC adopted it for the audit trail question.

Exchange Surveillance Enhancements

The Board of Trade's market surveillance system, CTR-PLUS, is built upon the world's finest audit trail, CTR. Regardless of their excellence, CTR and CTR-PLUS are new systems, fully operational only since July, 1987. Therefore, independent of recent events, the Exchange has been evaluating improvements and enhancements to the system. These recent intensified committee reviews have already resulted in Board approval of the following significant enhancements to the systems:

(1) CTR-PLUS now reviews every trade transacted on the Exchange.

Originally, , CTR-PLUS was created (as are all standard audit systems) to review a selected, statistically valid sample of data rather than the entire data base. Technical advances and commitment to improvement has now resulted in the expansion of CTR-PLUS review to every trade transacted in the Exchange's markets. This would be equivalent to the Internal Revenue Service auditing every taxpayer's return rather than the statistically valid sample which it does. The result should be not only greater effectiveness of trade practice surveillance, but also greater deterrence to any potential abusers.

(2) The Board has authorized one million dollars for CTR and CTR-PLUS improvements.

Sophisticated, effective surveillance systems require the investment of both expertise and capital. The development of CTR and CTR-PLUS was never hindered by budget restrictions. Nevertheless, to further enhance the systems will require additional funds. The million dollar fund approved by the Board evidences the Exchange's commitment to continued system enhancements.

(3) Trade bracket recordation times will be reduced fifty percent (50%).

The effectiveness of CTR-PLUS is in part dependent upon the time-bracket periods used by floor traders to time trades. Currently, thirty (30) minute bracket periods are required. The Board has approved reducing those periods to fifteen (15) minutes, a significant improvement. As a result, the already high accuracy rate of CTR times should improve.

(4) Market openings and closings will receive separate, five (5) minute trade time recordation brackets.

A substantial portion of the volume in any market occurs during the opening and closing periods. To improve the audit trail and surveillance of these critical periods, the Board has approved separate five (5) minute brackets for these critical periods of trading.

(5) Trade card recording requirements have been strengthened and improved.

The CTR and CTR-PLUS systems rely in part upon the accuracy of trade data reflected on a floor trader's individual trading cards. The accuracy of those systems will be further enhanced by Board approval of new requirements: (1) all trading card records must be accounted for; (2) all trading cards must be collected by clearing firms on an hourly basis and time-stamped; and (3) all trades must be submitted to the Clearing House within one hour of collection. These steps will not only enhance the audit trail and surveillance systems, but the clearing process as well.

(6) CTR-PLUS has been technologically enhanced.

Being a computerized system, CTR-PLUS is able to be improved by technological innovations and enhancements. The Board has approved several such enhancements to CTR including: (1) an expanded relational data base to permit more rapid investigations of trading activities extending back in time from those subject to investigation (i.e. expanding from a "snapshot" of trading activity to scroll over an extended period of trading activity); (2) expansion of the number and nature of surveillance tests conducted on a routine basis; (3) use of expert systems technology which will permit investigators to quickly design programs to specific needs; and (4) expanded storage capacity which will permit access to one year's data. These technological enhancements should speed investigations and increase the efficiency of professional investigator resources.

(7) All exchange floor clocks will be synchronized to an Exchange master clock.

A critical element of CTR and CTR-PLUS is accurate times. Currently, there is no requirement that the hundreds of Exchange trading floor clocks which are used to time stamp customer orders be synchronized to within ten-second intervals across the floor; therefore, minor discrepancies in times can occur which may affect CTR logic. The Board has approved synchronizing all exchange trading floor clocks to one master clock to insure uniform, accurate time information being input into CTR.

(8) Five (5) computer programmers have been added to enhance all OIA surveillance programs.

As noted previously, the Exchange regards the self-regulatory process to be evolutionary, not static. OIA currently employs a wide variety of excellent computer programs to assist their surveillance and investigative efforts. However, those efforts can be enhanced by the addition of new staff dedicated solely to improving existing programs and writing new ones. The Board's approval of five (5) additional programmers will greatly enhance OIA's efforts.

Office Investigations and Audit Enhancements

(9) An increase of OIA personnel by thirty percent (30%) has been approved.

OIA's staff has always maintained the highest degree of professionalism and efficiency. Because training for OIA staff positions effectively occurs only at the Exchange, hiring qualified personnel and training them expeditiously is a constant challenge. The Board has recognized that additional professional personnel to support OIA's efforts will enhance all of OIA's efforts. Therefore, the Board has approved a thirty percent (30%) increase of OIA professional staff over 1988 budgetary levels.

(10) Attorney staff exclusively supporting OIA has been tripled.

The Legal Department of the Exchange provides legal counsel to OIA as it does all Exchange departments. While all attorneys are involved in the self-regulatory process, previously only one attorney was assigned to exclusive OIA liaison and support duties. In consideration of the ever-increasing public scrutiny of Exchange disciplinary actions, the Board has approved tripling OIA's legal support to encompass three attorneys whose efforts are devoted entirely to supporting OIA. This increased support will increase the efficient use of OIA staff efforts.

(11) Professional investigative consultants have been approved for OIA training.

Surveillance and enforcement techniques for futures markets are more an arcane art than a precise science. The best training for new OIA staff is by existing OIA staff and Exchange members. Nevertheless, some investigative techniques are common to many markets. Therefore, the Board has approved institution of special training programs in investigation techniques for OIA staff to be conducted by non-Exchange professional consultants. The additional training should enhance OIA's existing excellent investigation efforts.

(12) OIA floor surveillance time has been increased.

Given the conjecture that the grand jury investigation is concerned with potential floor trading abuses, some question has been raised regarding whether an increased presence of OIA investigative personnel on the Exchange trading floor would enhance detection of trading abuses and provide an increased deterence to potential abusers. It has been the Exchange's experience that floor trading abuses are rare at the Board of Trade and that when they do occur, they are sophisticated and subtle enough to be detected best by fellow traders and/or sophisticated computer surveillance such as CTR-PLUS. Nevertheless, the Board has authorized additional dedication of OIA investigators to trading floor presence and observation. Although the returns on such an investment of valuable resources may be small, public confidence in floor trading integrity makes such efforts worthwhile.

Board of Directors Composition

The Exchange's Board is currently a diversified, expert body consisting of twenty-four (24) representatives from all aspects of the membership, industry and general public. The Rules of the Exchange require and foster that diversity. For example, Rule 102.00 requires that the committee which nominates Director candidates "... give special consideration to the desirability of having all interests of the Association represented on the Board." Moreover, the Nominating Committee itself is elected from the diverse Exchange membership which includes individual traders, FCMs, broker dealers, banks, commercial firms, institutional investors and others.

Thus, the Board of Directors currently is comprised twenty-four (24) members which fall into the following categories:

(1) three (3) non-members from the general public sector (which have included a former United States Attorney General, a Nobel Prize winning economist, the chairman of a national agricultural association and other similar extraordinary public figures);

(2) three (3) non-resident members who, being required to have their principal place of business more than fifty (50) miles from Chicago, effectively are quasi-public Directors;

(3) eight (8) member Directors who are currently principals or officers of member firms and thus represent the FCM/broker dealer community;

(4) six (6) Directors whose principal occupation is as a broker executing customer orders on the floor of the Exchange;

(5) three (3) individual members whose principal occupation is being an active trader on the floor of the Exchange for their personal accounts (i.e. a "local" trader); and

(6) the President of the Exchange, a non-member with no trading privileges.

Thus, the Board is currently very diversified representing all aspects of the industry as well as the general public.

Any criticism of the Exchange's Board as being biased toward members or one aspect of the membership is simply contrary to the facts. Furthermore, present Rules and policies will insure continued diversity of representation; no new rules or legislation are required.

Nevertheless, the Exchange's Board has enhanced its authority and policies in two significant ways.

(13) Board fining authority has been increased more than three hundred percent (300%).

As described previously, the Board of Directors sits as the ultimate disciplinary body of the Exchange, either in an appellate capacity or by referral from a subordinate committee. Historically, the Board has always found its authority to suspend, expel and otherwise sanction to be more than adequate. However, with the growth of institutionalized trading and the consolidation of member firms, the Board concluded that its current fining authority ($75,000 per violation) may not be sufficient in all instances to adequately sanction abuses, especially where larger capitalized respondents are involved. Therefore, the Board has approved for a membership ballot vote increasing its fining authority more than three hundred percent (300%) to $250,000 per violation.

(14) The Board has reaffirmed through formal resolution its long-existing policy of excluding members with histories of significant trade practice abuses from participation on the Board and major Exchange disciplinary committees.

The Board has long had a policy barring members with a history of significant trade practice sanctions from participation on the Board itself or on either of the Exchange's major disciplinary committees, the Floor Governors and the Business Conduct committees. The Exchange is committed to maintaining the utmost integrity of the self-regulatory disciplinary process and those who administer it. To insure that there is no doubt concerning this continuing commitment, the Board has approved a formal resolution approved by the Exchange's Rules Committee reaffirming and formalizing this long-existing policy.

Floor Practice Enhancements

The Board of Trade has historically adopted all its Rules, especially trade practice rules, to meet the highest standards of integrity and efficiency. Existing rules proscribe unjust and inequitable trade practices, forbid trading ahead of customer orders, insure that any profit resulting from the erroneous execution of a customer order goes to the customer, prohibit pre-arranged and accommodation trades as well as prohibit all other forms of trade abuse. The Exchange believes that these existing Rules are more than sufficient to deal with all potential trade practice abuses. Nevertheless, as part of the on-going review of all Exchange operations, the Board has approved several enhancements to floor practice regulation.

(15) All broker associations must be registered with the Exchange.

Associations of floor brokers sharing profits, expenses and losses, particularly with the inclusion of local traders, do not exist at the Board to the best of the Exchange's knowledge. Such associations do exist at other Exchanges and present those Exchanges with unique self-regulatory challenges to insure market integrity. The potential for abuse of customer orders and market efficiency due to broker groups is, therefore, not present at the Board of Trade.

However, some independent brokers at the Exchange do share order decks to facilitate customer order execution especially in options contracts where liquidity in deep out-of-the-money options is thin. Others share the expense of common clerks. To insure that these arrangements do not evolve into potentially abusive ones, the Board has approved that all associations of brokers which share income must register with the Exchange providing certain information to enhance surveillance of their activities. The Board is committed to preventing any potential abuse of customer orders which would result from the otherwise legitimate business relationships of member floor brokers.

(16) The Exchange has approved a modified closing call rule to enhance the efficiency of the market close.

Market-on-close orders, if entered late, can create problems in achieving an efficient, narrow and accurate closing range. Efficient closing ranges are essential to the commercial usage of futures contracts, especially as a pricing mechanism for cash market transactions. The addition of the modified closing call provides an opportunity for such late entered orders to be completed and for individual floor traders to "even-up" after providing liquidity for closing orders. Also, a more efficient closing range facilitates a more accurate settlement price which frequently is the basis for cash market pricing.

New Regulation 1007.02 would establish an additional two-minute trading period for all contracts at the conclusion of trading sessions. During this period, transactions could take place only at prices within the previously established closing range. No new orders could enter the pit, but cancellations would be permitted. Stop orders and limit orders elected by the closing range could be filled during this period.

The Exchange believes that the establishment of a modified closing call will benefit public customers for a number of reasons. First, more efficient closing ranges benefit cash market pricing. Additionally, because the new procedure will enable individual floor traders more readily to adjust their positions (to "even-up"), they will be more willing to provide liquidity to the closing public orders at the most competitive prices. Finally, no trade made during the modified closing call would be advantaged over those made previously in the market due to the restriction of prices to those established previously by the closing range.

The Exchange also notes that the audit trail for the modified closing call will be precise because the closing call period will receive a separate CTR designation, thereby enhancing the Exchange's surveillance capabilities for this period.

(17) The Board has approved prohibiting floor clerks from having trading accounts.

Floor clerks are responsible for the clerical handling of customer orders and other trade documents. While having no trading privileges, clerks are nevertheless intimately involved in the trading process. Because of that involvement, clerks are often tempted to trade for their own account. While such trading has historically served as a valuable means of apprenticeship training to become a member, the Board has determined that the rights of membership trading must be restricted to those who pass the intensive membership admission process. Therefore, the Board has approved prohibiting floor clerks from maintaining trading accounts.

Additional Technological Enhancements

The Board of Trade has not limited technological innovation to the creation of CTR and CTR-Plus. The Board of Trade is one of the most technologically advanced marketplaces in the world. Two aspects of that technological supremacy are worth noting in the present context.

(18) The Exchange's electronic order-entry system ("EOS") will not only increase the efficiency of customer order execution and clearing, but also the accuracy of CTR.

For many months, long before the current news of a grand jury investigation, the Board of Trade has been developing an advanced, electronic order-entry system ("EOS"). Electronic order-entry will speed communication of customer orders to the trading floor, expedite confirmation of execution back to the customer and submit trades for clearing directly. These enhanced efficiencies will not only serve customers better and reduce FCM expenses, they will also provide a computerized record of customer orders with times accurate to the second. This enhanced timing will improve the accuracy of the CTR audit trail and, therefore, the efficiency of the CTR-Plus surveillance system.

Approved by the Exchange membership on November 10, 1988, EOS is now on a prototype basis. As use of the system grows, accuracy of CTR data will be enhanced even further.

(19) The Board has approved further, intensive investigation and development of a hand-held trading terminal.

Just as EOS will enhance customer order time data, a hand-held computer terminal to replace trading cards would not only provide on-line clearing of trades, but also unimpeachable trade time execution to the nearest second. However, no current technology exists to create such a device for use in the auction market. For this reason, the Board has approved significant expenditures of Exchange staff and member committee time to work with outside professionals in developing such a terminal to meet the needs of our markets. Preliminary work has already begun. Hopefully, these efforts will lead to the development of suitable technology within a few short years.

CONCLUSION

The combination of sophisticated computerized surveillance systems and the vested self-interest of the Exchange's rigorously screened membership in the preservation of market integrity combine to create an extremely effective mechanism for the detection of potential exchange trading floor abuses. The Board of Trade has never condoned - and does not condone today - any trade practice abuse; proven offenders have always been appropriately sanctioned including fines, suspensions and expulsions.

Nevertheless, the Board of Trade recognizes that success is an evolutionary process, not a static one. Thus, despite creating CTR and CTR-PLUS - the world's finest audit trail and surveillance systems - the Exchange has considered all means to preserve and improve market integrity. The result of the most recent, intensive internal study is the twenty one (21) point program of enhancements detailed herein. These improvements (and others still under consideration) will insure that the Board of Trade's markets remain the world's most efficient, liquid and economical with the highest degree of integrity and professional participation.

In considering these issues, we urge this Committee to remain mindful of the dreadful consequences of precipitous, hastily considered action. While currently the world leader in futures markets, the U.S. could easily lose this unique and valuable industry to eager foreign competitors if ill-considered regulation is mandated. Therefore, critically valuable trade practices such as broker trading must be carefully evaluated, especially where their value is indisputably documented and no evidence exists regarding any abuses.

In fashioning any legislation, this Committee should also look with pride to the precedent set in 1986 regarding the audit trail issue. Then, the CFTC goal of one-minute time identification was left to each separate exchange, with its differing membership and markets, to best determine how each one should meet that goal. The result of this management-by-objective approach was the creation of CTR, the world's finest audit trail. If Congress acts similarly now after careful study, the result should be the continued improvement of what are already the world's most honest, liquid and efficient futures markets. This is the goal we all share.

Appendix 1: Foreign Competition Tables

Table 1

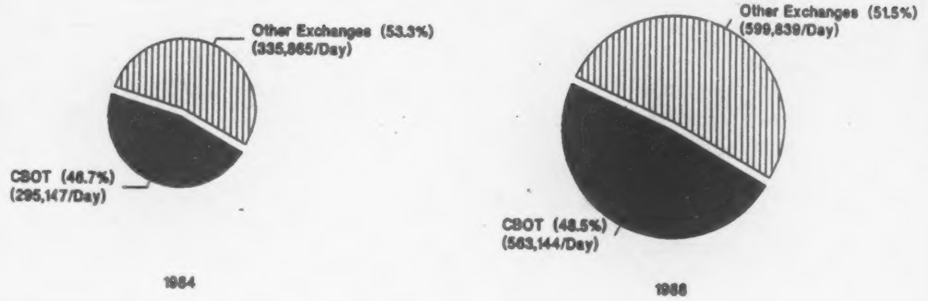
Volume Growth Rates: U.S. and World Futures Exchanges; 1984-1988

	Average Daily Volume 1984	Average Daily Volume 1988	Growth Rates (%)
CBOT	295,147	563,144	90.8
Other U.S. Futures Exchanges	335,865	599,839	78.6
Foreign Futures Exchanges	152,000	495,549	226.0
U.S. Market Share	80.6%	71.7%	
Foreign Market Share	19.4%	28.3%	

Figure 1

CBOT Market Shares of U.S. and World Futures and Futures Options Volume; 1984 vs. 1988

U.S.



WORLD

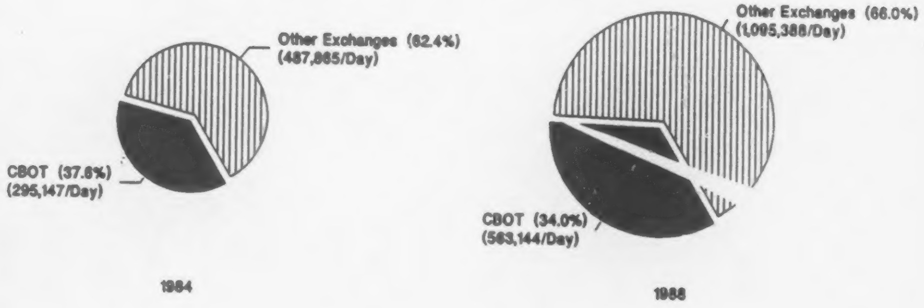


Table 2

Contracts Trading at the World's Futures Exchanges

U.S. Futures Exchanges	1984	1985	1986	1987	1989
No. of Contracts Listed	94	108	120	124	127
Growth Rate (%)		14.9	11.1	3.3	2.4
Foreign Futures Exchanges					
No. of Contracts Listed	125	129	172	178	230
Growth Rate (%)		3.2	127.7	3.5	29.2

Table 3

Ten Most Actively Traded Contracts on Futures Exchanges Worldwide 1985-1989*

Rank	1989*	1988	1987	1986	1985
1	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES
2	Chicago Mercantile Exchange Eurodollars	Chicago Mercantile Exchange Eurodollars	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange S&P 500 Futures
3	NY Mercantile Exchange Crude Oil Futures	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Board of Trade TREASURY BOND OPTIONS
4	Chicago Board of Trade TREASURY BOND OPTIONS	NY Mercantile Exchange Crude Oil Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange Eurodollar Futures
5	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	NY Commodity Exchange Gold 100 oz.
6	MATIF French Government Bonds	Chicago Board of Trade SOYBEAN FUTURES	NY Mercantile Exchange Crude Oil Futures	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade SOYBEAN FUTURES
7	Chicago Board of Trade SOYBEAN FUTURES	MATIF French Government Bonds	MATIF French Government Bonds	NY Mercantile Exchange Crude Oil Futures	Chicago Mercantile Exchange Deutschemark Futures
8	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange S&P 500 Futures	NY Commodity Exchange Gold 100 oz.	Chicago Mercantile Exchange Deutschemark Futures	Chicago Board of Trade CORN FUTURES
9	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Silver 5000 oz.
10	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Mercantile Exchange Swiss Franc Futures

*January - March, 1989

Table 4

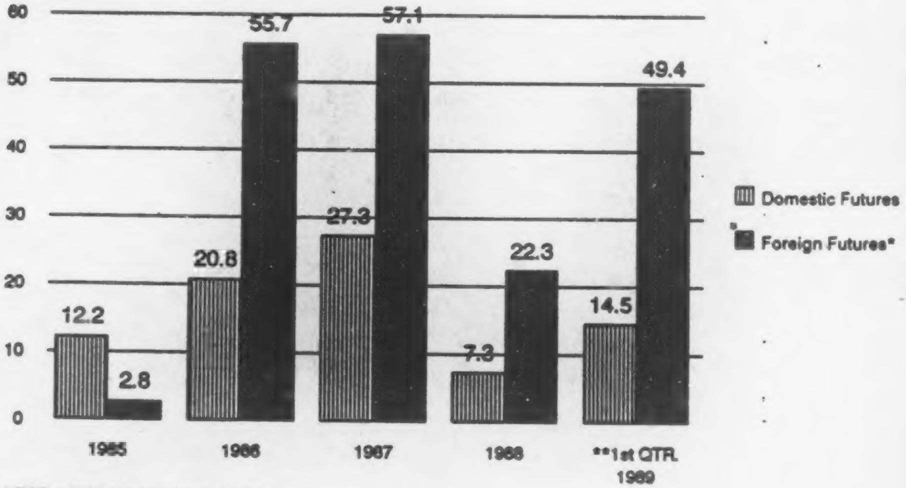
Number of Foreign Futures and Options Contracts
Traded in the Top 25 by Volume in the World; 1984-1989*

1984	1985	1986	1987	1988	1989*
0	0	1	3	4	6

*January-March, 1989

Figure 2

Annual Growth Rates; 1985-1989**
U.S. Futures Industry vs. Principal Foreign Futures Exchanges*
(percent)



* TSE, LIFFE, MATIF, SFE, SIMEX

Table 5

Volume Growth of Financial Futures and Options Contracts Trading on Foreign Futures Exchanges 1985 - 1989*

	1985	1986	1987	1988	1989*
Government Bond Futures and Options					
Average Daily Volume	13,686	77,980	171,723	189,751	218,038
Growth Rate (%)	--	469.8	120.2	10.5	14.9
Stock Index Futures and Options					
Average Daily Volume	1,590	6,655	59,914	47,428	75,305
Growth Rate (%)	--	318.6	800.3	-20.8	58.8

*January-March, 1989

Table 6

FOREIGN COMPETITION

Treasury Bond Futures Volume; Chicago Board of Trade and London International Financial Futures Exchange October 1, 1987 to October 30, 1987

Date	Chicago Board of Trade Night Session	Chicago Board of Trade Day Session	Chicago Board of Trade Total	LIFFE Total
10/01/87	23,466	261,753	285,219	5,970
10/02/87	9,047	368,448	377,495	995
10/05/87	10,963	267,009	277,972	4,336
10/06/87	7,623	244,259	251,882	7,890
10/07/87	10,522	362,278	372,800	8,525
10/08/87	10,626	442,189	452,815	6,891
10/09/87	15,363	308,742	324,105	7,775
10/12/87*	10,370	84,586	94,956	3,391
10/13/87	14,887	278,275	293,162	6,317
10/14/87	12,100	511,021	523,121	14,482
10/15/87	19,270	640,217	659,487	12,538
10/16/87	21,967	365,532	387,499	2,461
10/19/87	28,892	483,949	512,841	13,503
10/20/87**	28,269	34,487	62,756	47,082
10/21/87	44,552	311,180	355,732	15,955
10/22/87	13,933	366,911	380,844	12,465
10/23/87	28,266	323,253	351,519	16,079
10/26/87	19,203	272,409	291,612	12,529
10/27/87	20,937	280,655	301,592	13,398
10/28/87	15,270	337,029	352,299	10,900
10/29/87	15,542	224,911	240,453	9,537
10/30/87	17,400	220,040	237,440	7,352
Average Daily (Year-To-Date)	12,385	286,505	297,121	6,186

* Columbus Day; Banks and some financial institutions closed.
** Day session locked limit up.

Appendix 2: Broker Trading (CFTC Submission)

Study of the Role of Broker Trading at the Chicago Board of Trade, MidAmerica Commodity Exchange and Chicago Rice and Cotton Exchange

Prepared by Staff of the Three
Exchanges in Response to a CFTC
Request of March 8, 1989

Table of Contents

I Executive Summary/Conclusions 1

II Introduction 2

Scope of the Study 2
Organization of the Study 4

III Nature of Broker Trading 5

Definition 5
The Broker Trader as a Businessman 7

IV The Futures Markets at the CBOT, MACE and CRCE and the Effects of Broker Trading Activity on these Markets 10

The Nature of the Markets at the Three Exchanges 10

The Benefits of Broker Trading 11

Broker Trading and Liquidity 12
Customer Benefits from the Existence of Broker Trading 13
Provisions of Reserve Brokerage Capacity to Meet Future Needs 16

V Concern with Potential Abuses that may be Associated with Broker Trading 18

Nature of Potential Abuses 18
Prohibition and Restrictions 23
Ill-Conceived Proposals to Restrict Broker Trading 24

VI Conclusions 26

Appendix A: Examples of Trading Techniques Employed by Broker Traders A1
Appendix B: Broker Traders and Market Liquidity B1
Appendix C: Letters from Market Users C1
Appendix D: Alternative Market Mechanisms for Liquidity D1

I. Executive Summary/Conclusions

The practice of broker trading, or trading as a principal and as an agent, is widespread in the United States and abroad. At the request of the Commodity Futures Trading Commission, staff of the Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange have prepared the following study which describes and analyzes broker trading as it is practiced on the floors of the three futures exchanges.

This should be viewed as a preliminary study, as thorough study of the contribution of broker trading at the Exchanges would require more time than was allotted by the CFTC. As part of its further analysis, the CBOT has commissioned Professor Sanford J. Grossman of Princeton University to conduct a study of the role of broker trading in the futures and broader financial markets.

This study demonstrates that there are two principal benefits which broker trading brings to the futures markets. First, because broker traders are permitted to trade for their own accounts, they are able to engage in trading strategies in the course of executing a customer order which result in a better price for the customer than can be obtained by a broker who does not trade for himself. The study provides detailed examples of these trading strategies, describes the specific advantages customers derive from broker trading and presents letters from customers explaining why they prefer to have their orders executed by broker traders.

The second benefit of broker trading is that it adds substantial liquidity or depth to the market. The study shows that between 25% and 80% of the risk capital available in the markets examined is provided by broker traders.1/ Since broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets, and more capital, and this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity is provided by broker traders (for the benefit of all market users), presents further statistics describing the extent of broker trading activity at the three Exchanges, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

1/ The study points out the flaws with the definition the CFTC asks the Exchanges to use for purposes of the data analysis.

The analysis discusses the special contribution which broker trading makes in the markets at the three Exchanges. Extensive spreading activity has characterized the contracts at these Exchanges, which together with broker trading has been a key part of these particular markets and has helped them become the most efficient in the world. The price relationships among the delivery months in the grains contracts, for example, are the basis for hedging long term storage costs, an application of spreading which is an integral part of the U.S agricultural industry. Likewise, the cost of carrying government securities can be hedged through spreading in contracts such as Treasury Bond futures at the Exchanges. The role of broker traders in facilitating inter- and intra-market spreading, thus distributing liquidity across commodities and delivery months and forcing bid/ask spreads (customer costs) as low as possible, is particularly critical in these markets.

In addressing concerns that potential trading abuses may be associated with broker trading, the analysis carefully differentiates between the practice of broker trading and potential trading abuses which may use that practice as a vehicle. The practice of check writing is occasionally abused by some who draft fraudulent checks. Restriction or prohibition of check writing would not address the abuses. Ensuring that a sound means of detecting abuses is in place and that a stringent set of sanctions has been defined and is applied as appropriate is a more direct and logical approach to dealing with trading abuses than the restrictions or prohibitions of broker trading which some have proposed. Importantly, this approach would not damage market performance as a broker trading curb would.

The analysis discusses the Exchanges' CTR Plus system which enables staff to easily pinpoint any instances of abuse, explains enhancements which have been made recently and which are planned in this system, and describes penalties which are applied if trading abuse is detected. This self-regulatory system which combines ease of detection with strict penalties provides an effective deterrent of potential abuses which may be associated with broker trading at the Exchanges.

II. Introduction

Scope of the Study

An analysis of the nature and effects of broker trading2/ is presented in this study. The study has been conducted in response to a request by the Commodity Futures Trading Commission (CFTC) that exchanges undertake an analysis of "dual trading"2/ and its contribution to futures market

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2/ "Broker trading" is a more descriptive term than "dual trading" and will be used throughout this study.

performance. This study responds to the request sent to the Chicago Board of Trade (CBOT), the MidAmerica Commodity Exchange (MACE) and the Chicago Rice and Cotton Exchange (CRCE), three affiliated exchanges ["the Exchanges"].

In its letter to the Exchanges of March 8, the CFTC stated its request as follows:

> "Continuing increases in volume in the futures markets could indicate that exchanges may consider dual trading less useful for liquidity than formerly believed to be the case. Further, it has been suggested from time to time that limiting dual trading could inhibit certain trading abuses and decrease potential conflicts of interest. Therefore, the Division requests that the exchanges collect and analyze current data relative to dual trading in their markets to assist in such an evaluation of dual trading. In this connection, each exchange should submit dual trading data covering a representative period of no less than one week in late 1988 for its most active, a moderately active, and a less active contract. For this purpose, a dual trader should be identified as anyone who executes a customer type indicator ("CTI") 1 trade and a CTI 2, 3, or 4 trade during a single trading session. These data should include, but not be limited to, the following:
>
> - the number and percent of dual traders and non-dual traders,
>
> - the following information stated separately for the open, close, least active 1/2 hour bracket, and most active 1/2 hour bracket: the volume and number of transactions by dual traders and non-dual traders for each expiration for each contract chosen, separately identified as CTI 1, 2, 3 and 4 trades.
>
> The Division requests that your exchange provide a detailed analysis based on the foregoing data, and such other data as the exchange may deem relevant, together with an explanation of its methodology, as to the current need for dual trading in its markets. Your analysis should address whether or not potential limitations on dual trading could address the types of customer trading abuses actually encountered in exchange compliance programs. To the extent that you believe that restrictions on dual trading might unduly limit liquidity for particular markets, you should consider whether there are other mechanisms, such as the use of marketmakers, sunshine trading, or large or small order trade execution procedures which might serve the liquidity functions which historically have been attributed to dual trading."

This study presents only preliminary findings of the Exchanges' staff. Due to the volume of data under analysis and the complexity of the relationships between broker trading and futures markets, more extensive analysis needs to be done. This is not possible within the time constraints of the current April 30 deadline. Although the analysis which follows concentrates on futures markets, the Exchanges believe that the results of this study are applicable to the options on futures markets as well. The basic trading mechanisms in options and futures markets are identical and the role of broker traders is the same in both. The limitation of the analysis to futures reflects the time constraints.

As part of a more thorough analysis of broker trading, the Exchanges have commissioned Professor Sanford J. Grossman of Princeton University to study the role of broker trading in the futures markets and in financial markets generally. This study will be provided to the CFTC at a later date.

The Exchanges have serious concern with the CFTC's request which should be noted at the outset of this study. As will be shown in the analysis which follows, many traders will be termed "dual traders" (i.e., "broker traders") under the CFTC's definition[3/] not because they actively seek to trade for their own account as well as for their customers during a trading session, but rather because trades made in the course of executing customers' orders must be placed in the traders' "error accounts" (a type of proprietary account) if the trades are not specifically requested by the customers or are not in conformity with the customers' orders. The study will demonstrate that such proprietary trades result from certain strategies employed by the broker trader as he works to obtain the best price for the customer. However, the data requested by the CFTC will show, for example, that a given trader who has used these strategies will be shown to have executed proprietary as well as brokerage trades during a certain time period -- and, hence, will be a "broker trader" -- when, in fact, the trader was strictly trying to execute trades for his customers' benefit. Thus, the data can be misleading and must be interpreted with caution. A number of different definitions of broker trading are possible, which may well provide different data and different policy conclusions.

Organization of the Study

The next section examines the nature of broker trading, notes its pervasiveness in all financial markets and discusses the definition used in this analysis. Section III also discusses

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[3/] i.e., "anyone who executes a customer type indicator ("CTI") 1 trade and a CTI 2, 3, or 4 trade during a single trading session".

the economics of broker trading and the reasons a broker trader chooses to engage in the practice. (Appendix A presents examples of trading techniques that are employed by broker traders.)

Section IV examines the benefits of broker trading for the market as a whole, focussing specifically on the relationship between broker trading and market liquidity as measured by the bid/ask spread and market depth. (An empirical analysis of the current activity of broker traders, using the CFTC definition, is presented in Appendix B). The specific benefits derived by broker traders' customers are also examined. (Appendix C contains letters from customers of broker traders supporting the practice). Finally, it is demonstrated that broker trading serves the needs of the highly variable demand for brokerage services by ensuring that a ready supply of brokerage and liquidity services is always most readily available.

Section V examines potential abuses which may be associated with the practice of broker trading. It examines the nature of such potential abuses and, noting that they are not extensively found, discusses the safeguards currently in place. Finally, the section evaluates proposals intended to address concerns with abuses associated with broker trading, with respect to their effectiveness in limiting potential abuses and their effect on the functioning of the markets.

Finally, Section VI presents conclusions regarding the role of broker trading in futures markets.

(Appendix D discusses the role of broker trading and other types of trading mechanisms, with respect to the provision of liquidity services.)

III. Nature of Broker Trading

Definition

In the broadest sense, broker trading is practiced by any individual or firm that functions in a fiduciary relationship for a client as an agent or advisor and trades as principal for its own benefit as well. The futures market floor broker who also trades for his own account is but one example of a broker trader. Other examples of broker traders are individuals or firms that have knowledge of a potential trade execution or process the execution order, but may or may not perform the actual execution. In many financial markets in the United States and abroad, individuals and firms who act as both principal and agent are integral parts of the route followed by a customer order on its way to execution. The individual who initially takes the order, the firm he works for and the individual who ultimately executes the order may all be broker traders. In the case of futures trading in the United States, the phone broker who receives a customer's order may also be trading for his own account. The Futures Commission Merchant (FCM) that handles the order may be trading for its own proprietary account. The Registered Commodity Representative (RCR) may be trading for his own proprietary account. Thus, the trader on the floor of the futures exchange who ultimately executes the order may be one of several broker traders involved in handling a customer order.

While the example of an FCM is cited above, any provider of financial market brokerage services (e.g., a bank, a savings and loan, a credit union) could be a "broker trader". In financial markets, a brokerage concern that accepts futures or securities market brokerage and has proprietary accounts for trading in the same or an economically similar market (e.g., brokerage in stocks; proprietary trading in stock options) may correctly be labelled a "broker trader". Specialists are broker traders legally sanctioned by the stock exchanges to trade both for themselves and for others on the exchange floor. (It should be noted, too, that because the number of specialists is limited, there may be no alternative for those dissatisfied with their services.) Broker-dealers in the securities markets by definition are broker traders and are registered as such with their government regulator. In fact, although the securities industry has certain regulations regarding broker trading (i.e., trading as agent and principal), the recent history of indictments in the securities industry suggests that the so-called "Chinese Walls" set up by the industry to allow principal and agent transactions by the same economic entity may constitute more a porous screen than a real barrier.

Furthermore, it should be emphasized that broker trading is not strictly a U.S. practice. The practice is a principal mechanism for providing liquidity and executing customer orders in virtually every financial market of the world. For example, regulations in the United Kingdom were recently changed to permit single entities to engage in both proprietary and brokerage trading in the securities markets where such dual capacity trading had been prohibited previously. Broker trading is permitted and is prevalent on the floors of the London International Financial Futures Exchange (LIFFE) and the Marche a Terme des Instruments Financiers (MATIF), the two largest futures exchanges in Europe.

Despite the widespread practice of broker trading in the U.S. and foreign financial markets, we shall narrow the scope of the analysis and examine broker trading only from the perspective of the broker in the futures pit; specifically, the floor broker who may also trade for his own account.

Even from this perspective, the definition may vary, the previously expressed concern with the CFTC's definition notwithstanding. Is the broker trader a floor broker who could trade as a principal but does not? One who does trade as a principal? Does he trade both as principal and agent within the same time bracket? In the trading session? Over the last week? Does he trade in the same contract month as the brokered customer? A spread involving that same contract month? A back month? Another crop year? Different, but related, commodities? The choice of definition and scope of definition could clearly lead to different empirical results and conclusions concerning the role of broker trading, and may have different policy implications.

For the purposes of this study, we will concentrate solely on the ability of a broker to act as both agent and principal in the same pit. (In the empirical analysis in Appendix B, however, we use the CFTC's definition of a broker trader as one who acts as agent and principal in the same trading session.) Therefore, in the following discussion, actual observance of both types of transactions is not a concern and a temporal dimension can be ignored. Furthermore, to set aside discussion regarding the material nature of spot versus back month contract information, we will view the broker trader as one trading in both capacities in any contract month in a given pit. Of course, more complete study of broker trading would necessarily have to explore more fully the scope of the practice under its various possible definitions.

The Broker Trader as a Businessman

It is useful to consider a trader in a futures pit as a businessman. An individual undertakes trades as both agent and principal because it is a prudent business decision. In the simplest case, a broker trader may be an individual businessman who is primarily a broker, but who needs the flexibility to execute a proprietary trade either as part of his brokerage activities (see Appendix A) or, lacking brokerage demand, to take advantage of a business opportunity. Conversely, the broker trader may primarily trade for his own account, but at times may be asked to provide brokerage for other individuals. In the active grain markets of 1988, for example, the demand for brokerage services was so high that some traders who normally did not execute customer orders, were asked to do so and many existing broker traders found they had no time to even consider trading for their own accounts. In slower periods, they provide brokerage as needed but also have greater flexibility to pursue profitable trading opportunities for their own account.

The trading business has high fixed costs due to seat prices, dues and time spent on the floor. As a profit maximizing businessman, the trader will seek to increase product lines as long as variable costs of doing so are less than the price he can receive for the product. An increase in product lines, and presumably sales, increases overall profitability as fixed costs are spread over a greater number of sales. For example, the trader can take on brokerage activity with no additional fixed costs. Therefore, by taking on brokerage duties in addition to providing liquidity services to others in the marketplace, the trader can increase the overall profitability of the business.

As a business man, the broker trader has several goals. He hopes to have a profitable business. He knows he increases the likelihood that his business will be profitable and will endure if he provides the kind of services customers need. He wants to develop long term business relationships with these customers to ensure the continued success of his business. Thus he must focus his energies on helping the customers meet their own goals -- order execution at the best possible prices and at the desired time. If he does not help the customers meet their goals or if another broker trader does a better job of it, he will lose his business. The continued existence and viability of broker trading as a business is clear testimony of the success of broker traders in meeting the needs of their customers.

Customers are attracted to a broker trader precisely because he actively trades for his own account. His sense of the market and understanding of trading techniques which have been well-honed through his proprietary trading combine to enhance the quality of his brokerage product by enabling him to provide better order "fills" for his customers. (A discussion of broker trading strategies is presented in Appendix A.) In this role the broker may establish a spread by executing its two sides separately (i.e., by "legging") rather than merely accepting a spread available in the market; challenge what he feels is a wide bid/ask spread by bidding or offering a price different from that prevailing in the market; or disguise his customer's interest by raising questions in the minds of other traders as to whether the trade is being executed for a customer or for himself. Such activities are undertaken to improve the quality of the broker trader's brokerage services; i.e., to help customers meet their goals. This attracts more and repeated brokerage business and increases income for the broker trader only insofar as customers benefit from increased quality of "fills" or decreased cost of order execution.

Broker traders, like brokers who are not normally willing to risk making a proprietary trade in the course of filling a customer order, absorb the cost of their own mistakes in order-filling. These mistakes are placed in their proprietary (or "error") account.[4] However, in addition to losses related to mistakes in filling customer orders, broker traders may pursue trading strategies which force them to incur temporary trading losses in the course of getting the best execution for the customer. For example, consider a broker trader who has a large customer buy order to execute. After the broker trader executes a certain portion of the order, he finds that the offer price has risen, perhaps because opposing traders sense that there is a substantial quantity remaining to be bought by the broker trader, or for a variety of other reasons related to market conditions. Seeing this, the broker trader sells a quantity for his own account in an attempt to disguise his intentions to buy more contracts for his customer. This proprietary transaction might even reduce the prevailing market price for his customer's benefit. The offer price may fall and permit the broker trader to complete the buying for his customer at an advantageous price. If the price does drop, of course, the broker trader makes a profit on his proprietary position. If, however, the offer price rises, the broker trader may decide that the remainder of the order should be filled at the higher price (before it rises even more), which he deems would be in the best interest of the customer. In this case, of course, he loses money on his proprietary position, taken initially in an attempt to get his customer the best fill. (Further illustration of such strategies is given in Appendix A.) The above example illustrates the judgement which the broker trader must exercise in executing a customer order. The quality of this judgement sets the broker trader apart from other brokers in his ability to provide brokerage service. Customers seek to obtain the broker trader's good judgement -- and are willing to pay for it -- knowing that it has been developed and refined through his trading for his own account and knowing that they can continue to compare this service against the services of other competing broker traders.

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[4] The problems which this may cause in interpreting the data requested by the CFTC has been noted previously.

Some question why a broker trader would make a potentially losing trade to benefit a customer. Such a view concentrates on merely a portion of the broker's business and for only a short time period. The broker trader's rationale for establishing a potentially losing proprietary position makes more sense if one views the broker trader's activities in the market as a whole and considers long term relationships with brokerage customers; i.e., considers the broker trader as a businessman. If a losing trade borne on occasion by the broker trader leads to better fills for customers which in turn lead to more customer trades, the cost of the broker trader's loss should be offset in the longer run by the increase in overall trading. Some losing personal trades may therefore be viewed as a business expense by a broker trader desiring a large customer base. Broker trading, therefore, makes economic sense if used effectively for the enhancement of the brokerage services the trader provides.

As noted in Section V, severe penalties and high likelihood of detection explain why few violations of exchange rules occur through broker trading. However, some futures market customers may still prefer that their brokers specialize in brokerage. These customers may feel that brokers who do not trade for themselves provide better service or that they can avoid any potential abuses associated with broker trading. Customers having this view are not compelled to use broker traders. Customers have a choice to receive brokerage services from a broker trader or from a broker who does not trade for himself. The data suggests that this choice is exercised. For example, in the CBOT U.S. Treasury Bond futures pit on October 5, 1988, 81% of brokered trades (CTI 2, 3 or 4) were executed by broker traders for that day and 19% were executed by brokers who did not trade for their own account that day. In the CBOT Wheat futures pit on that day, the percentages were 89% and 11%, respectively. The data indicate a strong customer preference for brokerage services offered by broker traders.5/

To summarize, the businessman/broker trader chooses to trade for himself as well as his customer to increase the amount of services he supplies to the market (in hopes of increasing his income) and to provide his customers better service (in hopes of attracting even more brokerage business). Customers who do not receive the quality of brokerage service they need, will take their business elsewhere.

IV. The Futures Markets at the CBOT, MACE and CRCE and The Effects of Broker Trading Activity on These Markets

The Nature of the Markets at the three Exchanges

The provision of good spreading services is particularly important at the three Exchanges. Many of the contracts at the Exchanges are used for spreading to lock in cost of carrying physical commodities, such as grains. The price relationships among the specified delivery months create opportunities for hedgers in the grain markets to tailor the type of protection they obtain through their use of the futures markets to the period of time they will maintain their inventories. Use of these intermonth price relationships in the futures contracts for hedging is an essential part of the grain business.

Inventory issues are also a concern to those in the business of trading financial instruments such as U.S. Treasury Bonds. Many customers routinely using futures spreads to complement their storage or inventory operations direct their orders to broker traders who can execute spreads most effectively. The futures contracts which trade at the three Exchanges are widely used in conjunction with inventory management and thus the high quality spreading services which broker traders can provide are in particular demand.

5/ The CFTC definition of "broker trader" underlies these data. Problems with the definition have been noted earlier.

Furthermore, use of many of the contracts offered at the Exchanges entails routine rollovers (shifting a position from the nearby to a deferred month) at the expiration of contract delivery months. For the rollovers to be carried out efficiently, adequate liquidity is necessary in the deferred months. Spreading activity between deferred and nearby months is a principal source of liquidity in the deferred months. Broker trading is essential in all delivery months and perhaps particularly critical in the nearby months which provide the liquidity that the broker trader distributes, through his spreading, to the less liquid deferred months. Most of a broker trader's spreading activity includes a position in the liquid nearby month. He would be less willing to risk placing a position in an illiquid deferred month -- a position which might eventually be entered into his proprietary account if it does not fill the customers needs -- and thus would not provide deferred month liquidity, if he were unable to establish a corresponding position in the nearby month.

Broker traders are thus essential in servicing the needs of customers in the kinds of markets which trade at the three Exchanges. Their importance in not only providing quality fills for customer spread orders, but also in ensuring proper conditions for rollovers cannot be overstated.

The Benefits of Broker Trading

In general, broker trading provides benefits for futures market participants in three ways. First, broker trading enhances futures market performance by increasing market liquidity, yielding tighter bid/ask spreads and increased market depth. This is particularly important in less liquid pits and in deferred contract months and results in lower costs of order execution for the customer. Second, customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade gives a broker. Finally, broker trading benefits all potential futures market brokerage customers by maintaining a residual supply of brokerage services to meet a volatile changing demand. This is especially important in markets such as those at the three Exchanges whose risk (and demand for hedging brokerage services) varies widely from month to month, season to season, commodity to commodity. The active grain markets at the Exchanges in the summer of 1988 illustrated the importance of having a reserve supply of brokerage services which was demanded by customers on short notice as price volatilities and trading volume shifted sharply from hour to hour, day to day and week to week. Broker traders can respond to the brokerage demand whenever and wherever it occurs. Each of these benefits is discussed below.

Broker Trading and Liquidity

Liquidity of a market is its capacity to facilitate trade executions. A liquid market will enable market participants to execute orders of a certain size more easily and quickly than an illiquid market. The bid/ask spread, the difference between the cost of buying a commodity in the market and the cost of selling it at any point in time, is one widely used measure of liquidity. The spread reflects the ability to offset an earlier transaction (i.e., sell if one has purchased previously; buy if one has sold previously), thereby minimizing risk and cost of trading in the market.

The existence of broker traders in a pit adds more buying and selling capacity over a range of market conditions and makes more risk capital available to service hedging and investment needs of market participants. The institution of broker trading brings more capital to a pit and more traders to provide trading services. Market liquidity is enhanced as risk capital in the pit increases and trading costs are reduced. Risk capital is increased since brokers can establish speculative positions for their own account by broker trading. There is also an increase in risk capital in a pit due to increased trading opportunities. A trader able to do both brokerage and also trade for his own account, is more apt to find a satisfactory number of trading opportunities in a low volume pit than a trader who is more limited in his trading practices. The broker trader may find that a low volume pit provides adequate incentive to attract him to offer his trading services (brokerage and market making) in that pit. The increased risk capital which the broker trader brings to the pit lowers the bid/ask spread by providing additional opportunities for all market participants to offset a trade and by creating competition among market makers for a trade on the floor. The process feeds on itself as increased risk capital leads to greater liquidity, and since greater liquidity reduces the risk of committing capital to the market (it is easier to offset a losing trade), more risk capital is attracted. In the absence of broker trading, risk capital in the pit would be decreased, and trading costs would increase, to the detriment of all customers.

Broker traders in a pit can provide liquidity or market making services when brokerage demand is slack. For example, if a pit has 10 broker traders and 10 local traders, or market makers, the effective number of market makers available in the pit becomes 20. The additional market making capacity is always available (if brokerage demand is slack) with the presence of the broker traders. Moreover, this additional market making capacity is provided by experienced traders whose services can be made quickly available.

As requested by the CFTC, the Exchanges have compiled and analyzed data describing the extent of broker trading activity in the markets. The CFTC's definition has been used in the analysis despite the problems noted at the outset of the study which can cause confusion in interpreting the data. The analysis, which is necessary preliminary in light of the short deadline, is presented in Appendix B. The data itself is provided separately to the CFTC.

Customer Benefits From the Existence of Broker Trading

As noted in the numerous letters received from customers who approve of the practice of broker trading (see Appendix C), customers benefit from and continue to choose to use brokers who also trade for themselves. Customers recognize that there are several reasons their broker can give them better order fills because he is a broker trader. (Appendix A provides examples which illustrate these benefits.) First, customers know that because the broker trader also trades for himself, he has greater incentive to learn the subtleties of the market and therefore how to best execute an order.

Second, the broker trader can execute a customer order without signalling his intentions to the pit in a way that could adversely affect the price paid or received by the customer. Opposing traders do not know if he is trading for the customer or for himself. The ability of the broker trader to disguise his trading intentions is particularly important to his large customers whose large sized orders could otherwise receive a worse price. Furthermore, the confidentiality of the customer order can be preserved. This is particularly important to a customer who is a major factor in the cash market and whose business would be adversely affected if his competition (also futures market participants) knew his intentions (e.g., a large multinational grain firm with a pending export agreement).

Third, the broker trader can use his own account to help execute customer orders by "legging" spreads. Customers who want to initiate a spread position (the simultaneous purchase of one contract and sale of another in the expectation of a profitable change in the price relationship between the two contracts) require that two positions be established, a buy and a sell. It is often possible for the broker trader to obtain a spread (i.e., with both the buy and sell "legs") from another trader. Alternatively, the broker trader can execute the buy and sell transactions separately, thus constructing the required spread. This is called "legging the spread". A skillful broker trader is often able to "leg" the spread for the customer at a price which is cheaper than the cost of the spread available from another trader (see Appendix A). The customer benefits by receiving the spread he sought, and the broker trader benefits by satisfying the customer and probably keeping his business. Customers who monitor the price movements in the market and know what prices have been available in the pit will recognize that the broker trader went out of his way to fill the order. The businessman/broker trader will likely retain their business.

If broker trading were prohibited, many of the current broker traders would trade only for themselves and cease providing brokerage services. They would leave the brokerage business because they would not be able to draw on their trading skill to provide particularly high quality brokerage service to their customers. Thus, as compared to brokers who do not trade for themselves, they could offer no special incentives to potential customers to attract their business. Furthermore, under a broker trader prohibition, brokers would not be willing or able to employ the techniques used by broker traders because they could not risk a proprietary trade (see Appendix A). Broker traders would lose a trading advantage, or "edge", vis-a-vis local traders. The trading disadvantage which broker traders would then have relative to locals in the pit would cause broker traders to become locals trading only for themselves. With fewer broker traders to compete in the business of offering brokerage services, customer commissions and bid/ask spreads to customers would be expected to rise. Furthermore, as the best broker traders would trade solely for themselves, traders of lesser ability would act as brokers. Customers would be left with few brokers, less competition and only those relatively less talented brokers to fill their orders.

Because broker traders can trade for their own accounts, they have the obvious incentive provided by the profit motive to learn the subtle details of how the market behaves. Customers who execute orders through someone who also trades for himself know that they are dealing with a market expert. They benefit from the traders' ability to read market trends and provide them the best possible price and market information. Customers who do not like the quality of the execution they receive can change brokers. Customers monitor the quality of order fills and change brokers when warranted. A large number of qualified brokers are available on the floor of the Exchanges for customers to choose from. If a customer prefers to channel his orders through a broker who does not trade for himself, he may choose to do so. The continued existence of a large number of broker traders is proof of their value to customers. If there were an inherent bias against customers in the broker trading practice, customers would abandon broker traders in favor of brokers who do not trade for themselves and broker traders would cease to exist. Indeed, as noted earlier, there appears to be a customer bias in favor of broker traders in the pits at the Exchanges. (See the letters from the customers of broker traders, Appendix C.)

To ensure that they have the best broker for their needs and to compare the services provided by the available brokers, customers often "shop around" by, for example, asking several brokers to execute an identical spread. The broker providing the best service -- whether or not he is a broker trader -- ultimately gets the business over the long term.

As noted previously, another reason customers receive better prices when a broker trader executes their trades is that the trader is able to avoid revealing his (i.e., his customer's) intentions to buy or sell. This benefit is especially critical when a customer submits a large buy or sell order, or when a customer fill is needed without delay (e.g., at the open or close, or in volatile, fast moving markets) and the broker trader cannot wait for what he views as a temporary price disadvantage to correct itself. A broker trader can, and often will, protect his valued customer by, for example, disguising his customer's buy order by making a sale from his own account prior to executing the customer's buy order. This action may help prevent prices from rapidly rising before or during the execution of the order (large orders often cannot be executed entirely in one transaction and, instead, are executed in parts) and thereby helps the customer obtain a better price. In another situation, the broker trader may have a large customer buy order to fill but considers the prevailing offer price to be too high. In this case, the broker trader can sell a certain quantity for his own account in an effort to see if the prevailing offer price will move to a level he considers to be more attractive, given market conditions at that particular time. If the offer price does fall, he fills the customer order at the better price. These are examples of the kind of market judgement at which the broker trader excels and for which customers are eager to pay. (See Appendix A for further examples of how the broker trader exercises his judgement to benefit the customer.)

Although it might seem surprising that a broker trader would sell from his own account while holding an order that may indicate information that will signal higher prices, skilled broker traders do this in order to assure that customers get good fills. By keeping his customers satisfied, the broker trader/businessman assures himself a stable source of commission income, and that income is worth taking some risks in his own account. Competition from other broker traders in the pit may force him to take these risks. Moreover, the skilled broker trader may be required to bear these risks only temporarily since he may be able to offset them through other trades once the customer order is executed, for example, using spreads involving the liquid nearby month.

The additional liquidity generated by the presence of broker traders means that customers receive higher prices when they sell and lower prices when they buy. Large orders affect prices less in liquid markets. Furthermore, by allowing traders to also provide brokerage services, the practice of broker trading increases competition for brokerage customers and thereby helps keep execution costs low. In his 1981 paper, Stanley[6] works through several scenarios which demonstrate that brokerage costs would increase if broker trading were prohibited. Stanley's analysis demonstrates that, depending on the assumed cost of an exchange seat and the number of contracts that can be traded by a single trader each day, a ban on broker trading would result in some combination of increased total brokerage fees charged to customers and slower execution of customer orders. From his simulations, he concludes "...the dual trading commissions would always be less than the commissions without dual trading".

Provisions of Reserve Brokerage Capacity to Meet Future Needs

An additional benefit of broker trading is that it creates a pool of experienced trading expertise that can be drawn upon to meet periodic increases in the demand for brokerage services. The demand for brokerage services is directly related to price volatility. In a flat market, less brokerage demand exists. However, in a highly volatile price environment the demand for brokerage services will be very high. This can be observed on an intra- or inter-day basis. For example in the summer of 1988, drought conditions produced substantial increases in agricultural price volatility. This market environment increased the demand for risk management instruments and, therefore, for the execution services of floor brokers. Since most traders who regularly did brokerage were already swamped with the demand for their services, brokerage demands were placed on traders who normally traded strictly for their own account. Having the freedom to broker trade, these traditional locals were able to meet this increased demand. In the absence of broker trading, with shortages of brokerage services, brokerage fees would have had to rise sufficiently to offset the cost of brokerage start-up in order to elicit new brokerage supply. Floor brokerage fees were raised 20% per trade by many FCMs during the busy markets (The fees have since been reduced again to previous levels). The fees could have been raised much higher if reserve brokerage services had not been available from broker traders. Without broker traders, adequate brokerage services might very well not have been available at any cost in an hour, a day or a week if new brokers had to be trained from scratch. Since the practice of broker trading was possible, those start-up costs were minimal for locals already in the pit or in nearby pits. Without broker trading, risk management customers would not only have faced increased bid/ask spreads because of increased uncertainty in the volatile market environment, but higher brokerage fees and higher execution costs as the increased brokerage demand would have more likely been met with inexperienced or minimally experienced traders. Some customers would have had to wait for new brokers to be found. It might not have been possible to immediately meet the demand, even with inexperienced brokers.

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[6] Kenneth L. Stanley, "Measuring the Operational Costs of Dual Trading: An Analytical Framework," The Journal of Futures Markets, Vol. 1, No. 3, Fall 1981, pp. 329-336.

Full members of the CBOT, many of whom are broker traders, have certain trading rights at the Chicago Board Options Exchange (CBOE). Historically, when CBOE markets have been active relative to those of the CBOT, some of the CBOT full members have shifted the principal focus of their trading activities to the CBOE. This drain of brokerage services from the CBOT markets has occasionally caused shortages for customers when CBOT markets have suddenly become active. In such situations, the available brokerage services in CBOT markets have been reduced, and may not be immediately replenished by CBOT full members returning from the CBOE since they now have a commitment to trading there. Over time, if CBOT markets remain active, the full members may return and the total available brokerage services increase. However, the fact that this process takes time illustrates the difficulties a market can experience in immediately responding to increased brokerage demand by drawing on supply from another market. The reserve supply of brokerage services which broker traders provide to the market can be drawn on much more quickly.

Empirical analysis is needed to fully understand how the role of broker traders in the extremely active agricultural markets of summer 1988 compared with broker traders' role in earlier, less active periods. In particular, it would be necessary to study how the number of broker traders and brokers who did not trade for themselves differed in the two types of market conditions (e.g., in the corn and soybean markets at the CBOT in July 1988 vs. July 1987), and the trading volume and number of trades for which they were responsible. This is among the important topics relating to broker trading that deserves further attention.

From an economic perspective, flexibility for future decision making in an uncertain market environment has a value referred to as "option value". Option value usually has a cost associated with it. For example, a man may use his car to drive to work. However, he will be willing to pay for a public bus system to ensure that he has a method of getting to work if his car breaks down. The bus system has option value to him despite the fact that he may never use it. In the context of the futures market pits, broker trading has value to all potential futures customers. In times of increased brokerage demand, customers know they have a ready supply of brokers they can turn to. Broker trading provides flexibility and has option value. This option value presents no cost to these potential customers. Moreover, broker trading enhances market liquidity for the customers even when they do not need to call on the additional brokerage capacity it provides. It is an uncompensated positive contribution of broker trading that benefits the market generally. The more variable the level of demand from brokerage services, the more vital this reserve brokerage capacity becomes. Study of the variability of brokerage demand would further illuminate the value of broker trading.

To summarize, broker trading presents three major benefits which are particularly critical at markets such as those available at the three Exchanges. First, it increases market liquidity, producing lower bid/ask spreads and increased market depth. Second, when performed by a skilled trader, broker trading benefits the customer by providing superior execution services on the floor. Third, broker trading provides reserve brokerage services which may be called upon by future market users.

Concern With Potential Abuses That May Be Associated With Broker Trading

It is necessary to distinguish between broker trading -- a market practice that provides significant benefits to participants of futures and other financial markets -- and abuses associated with this practice. The Exchanges have an extensive self regulatory structure which defines trading abuses, including those which may be associated with broker trading, and prescribes penalties for those committing these abuses. Abuses associated with broker trading are easy to detect and despite the fact that the Exchanges police the markets aggressively, few instances of abuses committed by broker traders have been uncovered. Moreover, few customer complaints have been received. Currently, the penalties specified by the Exchanges focus on an individual broker trader or other type of market participant committing an abuse. By contrast, the extreme measure of prohibiting broker trading would provide no guarantee that the abuses would disappear while guaranteeing the elimination of the benefits of broker trading from the market. Moreover, such an extreme measure implies that the practice of broker trading itself is an abuse which, of course, it is not. Thus, the discussion of abuses which may be associated with broker trading must be framed carefully. Elimination or restriction of broker trading is not a panacea for market abuses, even for those abuses which a broker trader potentially could commit, in violation of Exchange rules. This point is obviously understood by the International Stock Exchange in London that recently changed its rules to allow broker trading.

Nature of Potential Abuses

Some have asserted that the ability to broker trade places a trader in a position with an inherent conflict of interest. Some say this conflict provides an incentive to breach the fiduciary duty that is owed to a customer. Although it is important to note that such a breach would have a minimal effect on the quality of futures market prices generally, it could adversely affect the quality of customers' fills. Two ways in which the quality of a given customer's fills could be reduced are:

1. Trading ahead of a customer's order.

   - This is against the rules of the Exchanges. Of course, a customer is harmed only if the act of trading ahead adversely affects the price he receives. However, the act of trading ahead is illegal, no matter how or whether the customer is affected. Traders found trading ahead of their customers are punished severely. Exchange rules provide for fines up to $75,000 per violation[7] and suspension or expulsion from the market. Expulsion from the Exchanges obviously constitutes a loss of livelihood and is thus an extremely severe penalty. The mere existence of this rule and its enforcement already discourages broker traders from executing proprietary trade close to the time of a customer order execution. The Computerized Trade Reconstruction (CTR) System (described below) can readily pinpoint an instance of a broker trader violating Exchanges' trading ahead rules.

2. Taking the other side of a customer's order.

   - This is a form of "bucketing" that denies a customer a competitively determined market price on a fill. It is against the rules of the Exchanges. It is illegal no matter what the effect on the customer. As with trading ahead, the practice is easily detected using the CTR system. Instances of this abuse occur infrequently at the Exchange, but when they do, the severe penalties noted above may be levied.

Neither of these abuses is inherent in broker trading, nor are they implicit to the broker trading practice. While each of these abuses is potentially remunerative, the disincentives to engage in such practices are so high as to offset the incentive for abuse. The disincentives to engage in these abuses are two-fold: a high probability of the detection of such violations through use of the CTR system and potentially high exchange penalties for violations ($75,000 fine,[8] possible expulsion). Furthermore, if a broker trader is found to be engaging in such abuses, he will likely lose his customers and, thus, his brokerage business, even if he is not expelled from the Exchanges.

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[7] The Board of Directors recently recommended an increase in fining authority from $75,000 to $250,000 that can be levied in cases of trading abuses.

[8] A $250,000 fine has been proposed.

As noted above, Exchanges employ the Computerized Trade Reconstruction ("CTR") System, the most-sophisticated audit trail and surveillance tool in the financial markets. The CTR System reconstructs the daily trading activity by computing the execution time of each transaction executed on the Exchanges' trading floors. The CTR System gathers the executing broker, executing firm, order entry time, quantity, price, order or trading card number, opposite broker and firm, and half-hour time bracket for every trade. Each time a price change occurs in the market, the new price, along with the exact time it was executed, is electronically recorded in the Time and Sales Journal by independent Exchange employees. The CTR System takes the trade data submitted into the clearing system along with the Time and Sales Journal information to calculate the time each trade was made to the nearest minute or less ("CTR TIME"), typically to the nearest second. The CTR Time is an essential element in the Exchange's ability to reconstruct the day's trading activity in any futures contract.

The CTR audit trail data then forms the basis for CTR PLUS, the surveillance systems which analyze CTR trade data for possible violations of CBOT Rules and Regulations. CTR PLUS has the ability to identify every trade in the market and isolate where potential problems might exist. The system identifies who made what trade, at what price, and when. Most importantly it looks at whether the price was reasonable given prevailing market prices at the time.

This year, as part of their routine surveillance program, investigators on the Exchanges' staff have begun to review all daily trading activity, using information that is available the morning after the trading date. This is analogous to the Internal Revenue System examining every single tax return for errors, rather than a random sample. The investigators routinely look for broker traders who trade ahead of their customers' orders by having CTR PLUS automatically search for instances when brokers receive a better price for their personal accounts than for their customer orders. Investigators also look for trading patterns suggestive of taking the other side of customer orders.

As noted by the "Brady Report"[9] released after the 1987 stock market crash, the audit trail systems of the U.S.

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[9] Report of the Presidential Task Force on Market Mechanisms, January 1988; p. 67.

futures markets are already superior to those available in the U.S. securities markets:

> "The futures clearinghouse and large trader information systems currently allow assessment of trading time by trading customers. The stock exchanges have no system which details trades and trading times by customer. Stock systems include only the broker-dealers involved and whether the broker-dealer acted as principal or agent. Customer information for all market segments is critical to assessing threats to the intermarket system, and all major exchanges should be required to maintain such an information system. The October experience illustrates the need for information systems capable of monitoring conditions throughout the one-market system."

The CTR Plus surveillance systems are a keystone of self regulation at the Exchanges. An accurate CTR system is necessary to detect any trading abuses, including those that may be associated with broker trading. No surveillance system is perfect but the CTR is the best available. Improvements costing $1 million have been planned which will enhance the system further.

To further increase the capabilities of the CTR and the CTR Plus systems in monitoring trading activity and pinpointing real or potential abuses, nine trade practice resolutions were unanimously approved by the Board of Directors, on March 2, 1989, for implementation no later than September 1, 1989:

1. Change the standard time bracket increment from 30 minutes to 15 minutes.

2. Establish a period of less than 5 minutes as the first time bracket for all contracts' respective trading sessions.

3. Establish a period of less than 5 minutes as the last time bracket for all contracts' respective trading sessions.

   - These tighter time bracket increments will permit increased precision in timing and confirming the timing of the trades of broker traders (and others). The change creates more and more accurate timing variables which can be used in the CTR Plus computer programs to pinpoint trading times.

4. Establish complete accountability by members and clearing firms for all sequentially-numbered trading cards on a daily basis.

- Broker traders (and others) will be held accountable for all of their pre-numbered trading cards and the accuracy of the sequencing information they contain.

5. Require that members' trading cards be picked up by clearing firms throughout the trading day at one-hour intervals from the opening of each respective market.

6. Require that clearing firms submit trades to the Board of Trade Clearing Corporation within one hour after the relevant trading cards have been collected from members.

   - The processing of trading data and the development of the audit trail relating to broker traders (and others) will be expedited. The change moves the information quickly and regularly from the traders to independent exchange and firm employees.

7. Require that all trading cards receive the Exchange-designated time stamp as they are taken from the Exchange floor.

   - This will provide another precisely-timed variable which can be used in pinpointing trading times of broker traders (and others).

8. Establish an Exchange floor "master clock" system, accurate to the nearest second, by which all time stamp machines on the floor would be synchronized automatically.

   - Any time discrepancies among time stamp machines which lead to errors in timing the orders and cards of broker traders (and others) will be eliminated.

9. Install an "automatic bell" on the floors of the Exchanges specifically to designate the time of each bracket change.

   - This change will facilitate the accurate recordation of time bracket information by broker traders (and others).

These changes are very much in the spirit of the ideas for improved futures market regulation proposed by Senator Patrick Leahy in his March 5, 1989 letter to the Exchanges. A principal proposal was for the CFTC to mandate improvements in exchange audit trails. These changes planned by the Exchanges represent the latest in a continuous series of enhancements in the Exchanges' market surveillance mechanisms. These enhancements will continue to improve the Exchanges' ability to detect abuses associated with broker trading and should also provide additional assurance to market participants that any abuses related to the filling of customer orders will be uncovered.

Prohibition and Restrictions

The costs of any abuses associated with broker trading are borne directly by the broker trader's customers, not the market generally. The best individuals for assessing those costs are these customers. The Exchanges have received few customer complaints of abuses related to broker trading. However, if a customer feels that broker trading imposes a cost on him, that customer can receive execution services through a broker who does not trade for himself. Conversely, if a customer desires order execution through a broker trader (the letters in Appendix C show that many customers do prefer the brokerage services of broker traders), they can receive such execution. Thus, customers who are dissatisfied with the executions of broker traders are free to direct their business elsewhere. However, the continued existence of broker traders provides clear market evidence that the brokerage services they provide are much in demand.

If there are concerns with the possibility that broker traders may commit some improprieties, prohibitions and restrictions are the least efficient methods of controlling these improprieties. Prohibition or restriction of the practice of check writing to eliminate or reduce the use of fraudulent checks would be similarly misdirected. Prohibitions and restrictions do not eliminate abuses but merely preclude one vehicle for the abuse. The abuse may still continue through another vehicle. Banning checks would force those who abuse the check writing practice to consider, perhaps, misuse of credit cards. Banning broker trading would eliminate any type of abuse by broker traders and would merely force a dishonest trader who seeks to violate Exchange rules to use another vehicle for doing so. Prohibitions and restrictions of broker trading may be easy to decree, but clearly are simplistic and would impose severe costs on those using the markets directly, as well as those who benefit indirectly from the existence of futures markets and the presence of broker traders without solving any real problems. Moreover, the focus of these prohibitions is misplaced since it is on a practice, not on an abuse.

Proposals calling for prohibitions and restrictions of broker trading certainly do not appear to be justified on the basis of a cost/benefit analysis of the particular proposals. A detailed cost/benefit analysis should certainly be done on any specific proposal before it is given serious consideration. Furthermore, although more work needs to be done to fully describe the benefits of broker trading, no evidence currently exists that suggests the actual costs of abuses associated with broker trading abuses are large or that some form of broker trading prohibition would provide such a cost savings as to justify its adoption. A prohibition of broker trading would not eliminate the potential for customer abuses. Such a prohibition may not even reduce the potential for abuses which are currently associated with broker trading if such abuses could also be committed with another trading vehicle.

As noted at the outset of this study, the practice of broker trading is widely used in the financial markets. If the total elimination of customer trading abuses is a social goal, the only solution is to close down all of our financial markets. The specialists trading on the stock exchanges, the broker dealers in the government securities market and all other broker traders would necessarily be included in any action. Of course, such a solution is not considered viable since all benefits of our financial system would be lost. The only reasonable approach to any problem of customer abuse involves enhancement of detection capability and imposition of appropriately large penalties for those found committing an abuse. Reducing the efficiency and raising the cost of doing business in the United States through ill-conceived prohibitions and restrictions of the beneficial practice of broker trading imposed selectively on one of the country's most important financial markets would certainly result in loss of markets to foreign competitors.

Ill-Conceived Proposals to Restrict Broker Trading

The following proposals to restrict broker trading have been put forth by various individuals concerned with the potential for abuses associated with broker trading. All are flawed, as explained below. The principal flaw, common to all these proposals, is that they focus on the practice of broker trading, which, itself, is not an abuse. Broker trading, like other practices in the financial markets such as investment banking, inter-market arbitrage, market making or options writing, can be conducted with or without abuses. A carefully constructed regulatory structure is necessary to define the abusive behavior, ensure that means of detection are adequate, and provide for penalties which will serve to deter wrong-doing. Such a regulatory structure exists currently and serves the interest of the customers better than any of the following proposed procedures.

1. Limit the size of customer orders which a broker trader is permitted to execute (e.g.; Order size must not exceed 1[illegible]0 contracts).

   This proposal would restrict the incidence of any abuse associated with broker trading to small customers, thus creating inequitable treatment of different types of customers. Large customers would be forced to break up their large orders among many broker traders or would have to rely on brokers who do not trade for themselves. As noted earlier, these brokers do not have the same facility to obtain the best price as the broker traders do. The incrementally lower quality fills for large orders could have a substantial adverse impact on large firms' operations. Since these large firms are very often active in world markets, aware of alternative trading opportunities abroad and positioned to take advantage of alternative international markets, significant business would be lost to foreign competition.

2. Limit a broker trader to a certain amount of brokerage activity during a session (e.g.; A broker trader is permitted to fill customer orders representing no more than 500 contracts in a session).

Again, the total volume affected by any abuses related to broker trading might be limited. However, the amount of brokerage services available in the pit would be severely limited, as well, and if market conditions resulted in a sharp increase in intraday demand for brokerage services, that demand could go unmet. In the long run, rising demand for brokerage services in a situation of limited supply would result in higher brokerage costs and/or the entry of possibly less skillful brokers who, at least in the short run, would provide lower quality fills. Customers would seek to obtain fills in other, less restricted markets.

3. Permit a trader to do brokerage at certain periods and proprietary trading at other periods. (i.e; He would be prohibited from trading for customers and himself in the same trading period.)

Under this proposal, the trader would not be free to practice broker trading. Once he committed to doing either brokerage or proprietary trading, he would be restricted to that single type of trading activity. If customer demand for brokerage services were to rise during a day when few traders have declared their intent to do brokerage, capacity would be inadequate to meet customer needs.

4. Prohibit broker trading in the nearby month.

Some contend that the liquidity services of broker traders are not needed in the nearby month where trading activity is the greatest. Thus, the reasoning goes, a ban of broker trading in the nearby month would at least eliminate abuses associated with broker trading in the most active month. However, prohibiting broker trading in the nearby month effectively would prohibit it in all months. When broker traders "leg" spreads or execute "rollovers" for their customers, the process involves various combinations of positions in the nearby and deferred months which must be placed and lifted at times and under circumstances dictated by market conditions

(See Appendix A). Loss of the ability to trade flexibly in the nearby month which provides the fulcrum for many of these strategies would require the broker trader to accept less advantageous prices for his customer.

5. Prohibit broker trading in liquid contract markets.

   This proposal is based on the view that the liquidity services which broker trading provides are not needed in active contracts; i.e.; that liquidity would be sufficient without broker trading. However this contention ignores the fact that deferred delivery months of even very active contracts are often illiquid. Broker traders, through their spreading and other trading techniques, augment liquidity in deferred months. Furthermore, customers demand the same high quality order execution, which broker traders provide, in liquid markets as they demand in less liquid markets. The provision of deferred month trading services depends importantly on broker trading in the liquid nearby months. Customer execution would suffer if broker traders were banned from active contract markets or delivery months.

6. Ban broker trading at the open and the close of trading, or in fast markets.

   When markets are trading actively, broker traders often are so busy executing customer orders that proprietary trading is not possible. However, removing the broker trader's ability to employ his unique trading techniques for the customers benefit in rapidly moving markets would lead to less satisfactory customer fills during these periods (see Appendix A). Further, such a ban would preclude the broker traders who need to do brokerage business at the open or close from filling errors from the previous day which they took into their own accounts.

7. Ban broker trading completely.

   All the liquidity and order execution benefits of broker trading would be lost to the futures markets. Customers would take their business to markets, perhaps overseas, which provide the liquidity and transaction services they require.

VI. Conclusions

The contribution of broker trading to market liquidity and to the effective execution of customer orders is substantial and not well understood by many of those suggesting that the practice be curbed. As the foregoing analysis has shown, outside customers of the futures markets -- the agricultural firms, the pension funds, the government securities dealers, the banks and others -- who use the markets to manage their business risks or for investment purposes would be among those entities which would be hurt the most by a limitation or a ban on broker trading. It is ironic that these customers are the intended beneficiaries of a broker trading restriction.

Broker trading cannot be limited or prohibited without substantial adverse (and, perhaps unintended) consequences. Vitally, as noted in the analysis, there is no guarantee that the abuses of concern would even be eliminated by such a measure. A more rational approach which does not adversely affect market performance is to enhance the regulatory framework that is already used to maximize the likelihood that those attempting improper trading practices will be caught and that they will be punished severely. The Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange have such a framework in place and are enhancing it at considerable expense to ensure that users of the markets are provided with the transaction services they require without the fear of abuse.

Appendix A

EXAMPLES OF TRADING TECHNIQUES EMPLOYED BY BROKER TRADERS

The principal benefits of broker trading are two fold. First, because the broker trader is permitted to trade for his own account, he is able to give his customers better order execution service. Second, in the course of seeking the best execution of his own customers' orders, he adds liquidity to the market and an important element of competition which keeps the bid/ask spreads narrow and costs low for all customers of the market.

In this appendix, these benefits will be illustrated through the description of certain trading techniques employed by broker traders. This is not an exhaustive description of all techniques used by broker traders.

Techniques Employed by Broker Traders to Provide their Customers Better Brokerage Service

1. **A Broker Trader Disguises his Intentions in Filling a Customer Order to Obtain a Better Price**

As part of his inventory hedging strategy, the manager of a grain firm submits an order to his broker trader to sell two million bushels of corn for delivery in May at the current market price. The customer hopes to obtain as high a price as possible yet he also needs prompt execution of the order since, until he is hedged, he is exposed to the possibility that the value of his inventory will fall.

Several thoughts run through the broker trader's mind when he receives this order. The broker trader knows that, on this day, offering to sell such a large quantity of corn in one trade would depress the market price substantially, and result in a very low price for his customer. Local traders would initially back away from taking the other side of the trade, recognizing that the broker trader had superior information and that by trading with him, they might incur a large loss. Furthermore, the broker trader feels that even if he divides the total order into smaller pieces (say, four trades of 500,000 bushels each), the market price will still be forced successively lower with the execution of each trade, yielding an unsatisfactorily low net price for his customer. Finally, the broker trader knows that other traders are aware that he often executes trades for large agricultural customers. He knows that if the other traders detect that he has a large sell order to execute (i.e., that he is trying to sell a large quantity of corn at as high a price as possible), they will not accommodate him immediately but rather will hold back, force the broker trader to lower the price at which he offers to sell for the customer, and buy from him only when the price reaches a lower level which is more satisfactory to them (and less satisfactory to the customer).

When the broker trader receives the order, the market price of May corn is bid: $2.65/bushel, offer: $2.66/bushel.1/ Because it is a market order, he immediately begins working to execute it. To disguise his intent to sell, he bids (signals an intent to buy) at $2.65/bushel for 500,000 bushels. This is merely a ploy. He has no intention to buy corn, but he hopes to convince other traders in the pit (i.e., traders with risk capital who he hopes will eventually buy part of his customer's order) that he does. He hopes no one will sell him corn but if they do, the trade will be for his own account.

In this case, his strategy works. No one sells corn to him and after a time he withdraws his bid. Other traders think his interest is on the buy side. Next he offers to sell 500,000 bushels of his customer's order at $2.65 1/2 per bushel. This is above the current $2.65/bushel bid price at which traders in the pit are buying corn. However, one trader the pit considers that the purchase of 500,000 bushels at $2.65 1/2 per bushel is an acceptable transaction and commits his risk capital to the purchase. Thus, the prevailing bid price rises to $2.65 1/2 per bushel. The broker trader knows that if he had not signalled an intention to buy previously (thus signalling an indication of information that could raise prices), the other trader would have been less likely to buy this quantity of corn at a price above the previous bid price.

The broker trader offers another 500,000 bushels at 2.65 1/2 per bushel but no one buys it. Other traders want him to lower his price. Because the customer needs prompt execution of the order to protect the value of his inventory, the broker trader reduces his offer price to $2.65/bushel. He is able to find a buyer -- perhaps the same buyer.

Now half of the customer order is executed at a net price of $2.65 1/4 per bushel, 1/4¢ above the prevailing bid price when the order entered the pit. However, the broker trader senses that the other traders have begun to realize that he is really interested in selling, rather than buying. The broker trader is concerned that if he offers to sell more of the customer's order in the current market environment, prices will drop quickly and he will not be able to execute the remaining one million bushels of the customer order at an acceptably high price. Again seeking to confuse opposing traders as to his true intentions, he bids for 500,000 bushels at $2.64/bushel, the level to which the prevailing bid has fallen. No one sells to him. He raises his bid to $2.64 1/2, attempting to signal firmness to the market before executing the remaining one million bushels of his customer's order.

1/ Traders in the pit are currently buying corn at $2.65/bushel and selling corn for $2.66/bushel. Thus, a customer wanting to sell corn at that moment could do so for $2.65/bushel; a customer wanting to buy, could do so for $2.66/bushel.

This time, another trader sells to him at this price. Because this transaction was not requested by his customer, it necessarily is considered his proprietary trade. However, he succeeded in strengthening the market and masking the fact that he has one million bushels to sell. At this point he offers the remainder of the customer order and is successful in filling it at $2.64 1/2 per bushel, the prevailing bid.

Summary

A broker who is unable to trade for his own account would not be able to disguise his intentions in this way. Each time the broker in the example attempted to mislead the other traders (and set up conditions for an advantageous execution of his customer's order) by signalling an intention to trade which was not consistent with the customers wishes, he faced the risk that another trader in the pit would trade with him. Such a trade could ultimately be profitable or it could result in a loss. Either way, it is necessarily a proprietary trade, making the broker a "broker trader", by definition. The broker who does not disguise his customers' intentions in this way will not take the risk of having unprofitable proprietary trades. However, in the example, if the trader had not disguised his customer's intentions, the order would certainly have been executed at a much lower price, to the customer's disadvantage.

2. A Broker Trader "Legs" a Spread to Obtain a Better Price

An investor submits an order to his broker trader to establish a spread position between June Treasury Bond futures and June 10-year Treasury Note futures at the current market differential. The Treasury Note price exceeds the Treasury Bond price and he expects that the spread will widen further in light of current market fundamentals. Thus, he wants to buy Treasury Notes and sell Treasury Bonds at the narrowest possible price differential to provide him with the greatest opportunity for profit if the spread widens as he expects.

When the broker trader receives the order, the market price for June Treasury Notes is 91 23/32 and the price of June Treasury Bonds is 87 18/32.2/ The current spread is thus 4 5/32. The broker trader has two options -- he can execute the entire trade (i.e., obtain both sides of the spread in one transaction) with another trader who specializes in spread transactions if the price is satisfactory for the customer; or he can buy the Treasury Notes and sell the Treasury Bonds in two separate transactions (i.e., he can "leg" the spread). The first option is easier for the broker trader but since

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2/ The price of these instruments is expressed as a percentage of par value of $100,000. Thus, the Treasury Note contract is currently priced at $91,718.75 and the Treasury Bond contract is currently priced at $87,562.50.

traders who specialize in spread trading often charge a premium for providing the complete spread, the price may not be the most advantageous for the customer. "Legging" the spread (i.e., obtaining the desired spread in two separate transactions) is more time consuming, difficult and risky for the broker trader, but a better execution for the customer is possible. If the market moves sharply while he is legging the spread and he is unable to execute a spread at terms which are at least as favorable for the customer as the complete spread, he may have to abandon his attempt to leg the spread, take the unfavorable spread into his own account (at a loss) and either obtain the spread from a spread trader in the pit or try again to leg the spread. He also knows that if, over a period of time he does not leg his customer spreads quickly as well as effectively, he might lose brokerage business to possibly less skillful brokers who would execute the spread order more quickly (albeit at a less advantageous price) by trading directly with the spread trades.

The broker trader finds that he can obtain the spread for his customer from a spread trader at 4 6/32, slightly above the 4 5/32 differential based on the current individual Treasury Note and Treasury Bond prices. The broker trader wants to give his customer the best possible execution in hopes of retaining his brokerage business. He thus opts to leg the spread in an attempt to save the customer 1/32 or $31.25/contract. He first buys the Treasury Note leg at the prevailing price of 91 23/32. However, when he attempts to sell Treasury Bonds, he finds the price has fallen to 87 16/32. If he sells the Treasury Bond leg at this price the spread will be 4 7/32, wider than the complete spread he could have purchased. Now, the Treasury Note price falls, as well, to 91 21/32 and the Treasury Note-Treasury Bond spread returns to a 4 5/32 differential. The spread trader is still making the spread available at 4 6/32. The broker trader still seeks to obtain the spread for his customer at the more favorable 4 5/32 differential and thus begins to leg the spread again. He takes the previous Treasury Note purchase at 91 23/32 into his "error" account since it now has no part in his legging strategy. (At this point, he thinks he may have to take a loss on this transaction since Treasury Note prices have fallen to 91 21/32.) This time he is successful in legging the spread for the customer, buying Treasury Notes at 91 21/32 and selling Treasury Bonds at 87 16/32. The customer receives a spread execution at 4 5/32, narrower than the 4 6/32 offered by the spread trader, and thus saves 1/32 or $31.25/contract. The broker trader attempts to offset the Treasury Note position in his error account, taken in his initial attempt to leg the customer spread, over the course of the trading day. He may or may not be successful in doing this.

Summary

A broker who was not a broker trader would probably have obtained for the customer the 4 6/32 spread available from the spread trader. It would have been the easiest and least risky route for him to take, but it would have been more expensive for the customer. The broker trader who is permitted to take a trade into his own account can, if he wishes, take a risk in the interest of providing the best execution for the customer. In this case, the broker trader took the risk and (at least initially) suffered a loss. The customer received a better price, however, and will probably continue to channel his brokerage business through the broker trader. The broker trader considers the loss he incurred on this trade to be a cost of doing business.

3. A Broker Trader Employs a Strategy to Obtain the Most Favorable Inter-month Spread Relationship

As part of his grain merchandising operation, a grain elevator wishes to establish a May/November soybean spread, expecting the spread to narrow. Specifically, the grain elevator wishes to sell 350,000 bushels of May soybeans and buy 350,000 bushels of November soybeans at the current market price (i.e., He wants to sell the May/November spread). When the broker trader receives his customer's order, the current market prices for spreads in the Soybean futures pit are:

May/November	25 1/2¢ bid/26 1/2¢ offered
July/May	3¢ bid/3 1/2¢ offered
July/November	29 1/2¢ bid/30¢ offered

The broker trader observes that another broker is bidding 29 1/2¢ for 500,000 bushels of the July/November spread (i.e., to buy 500,000 bushels of July soybeans and sell 500,000 bushels of November soybeans). He also observes that several local traders are bidding 25 1/2¢ for the May/November spread (buy May, sell November).

The broker trader bids 26¢ for 200,000 bushels of the May/November spread, above the prevailing 25 1/2¢ bid for the spread. A local trader who is trading spreads sees this and raises his own bid for the May/November spread to 26¢, as well. At this point, the broker trader withdraws his bid and sells 350,000 bushels of the spread to the local trader (i.e., sells the May and buys the November, as the customer wishes) at 26¢. The broker trader has thus achieved for his customer a price which is 1/2¢ better than the market price for the spread which prevailed when he received the customers order (i.e., He was able to sell the spread for 26¢ rather than 25 1/2¢).

To fully understand this example, it is necessary to understand the motivations of the local trader. He raised his bid to 26¢ for the May/November spread, following the broker trader, after observing a profit opportunity in the other available spreads. He felt that if he could buy the May/November spread (buy May and sell November) for 26¢, he could then sell the July/November spread (sell July and buy November) for 29 1/2¢ to the broker bidding that price for 500,000 bushels. This would leave the local trader with a May/July spread (long May and short July) at 3 1/2¢, which is the current offer price for that spread. This is an advantageous, and potentially profitable, position for him. Thus, the broker trader's tactic of bidding above the market bid price for the May/November spread caused the local trader to evaluate market opportunities for himself and, finding a profitable one, raised his own bid as well, eventually buying the customer's spread from the broker trader.

Summary

The broker trader risked buying the May/November spread at 26¢ because he was hoping to bring together information conveyed by several market interests and elicit a favorable customer execution. If another trader had sold the spread to him at that price, the broker trader would have had to offset this purchase somehow, possibly at a loss. He would have had to absorb any loss himself. However, as he had hoped, his tactic conveyed information to the market that elicited an increased bid price for the spread the customer wished to sell. The customer received a price which was 1/2¢/bushel better on 350,000 bushels, for a reduction in cost of $1750. The customer would not have benefitted by the higher price if his order had been executed by a broker who was not a broker trader.

How These Techniques Enhance Liquidity

In each of these examples, the broker trader has enhanced liquidity in the pit as he has endeavored to obtain the best order execution for the customer.

When the broker trader disguises his trading intentions (i.e., those of his customer) as in the first example, the bids and offers he makes in the course of the deception provide more trading opportunities for others in the pit, and hence, increase liquidity. While he may hope that no other traders accept these bids or offers, he runs the risk that they will. Brokers who are not broker traders would not provide this additional liquidity.

In the second example, the broker does not wish to accept the spread offered by the spread traders but instead "legs" the spread to obtain a more favorable spread for his customer. In this case, the broker trader promotes liquidity by counterbalancing the offers of other traders. If the offers of the spread traders were continuously accepted by others in the pit, the premium charged by these traders would not be challenged. The broker trader in the example did not accept the spread traders' offer and instead bypassed them to accomplish the desired spread himself. This imposes discipline on the spread traders who may decide to reduce the premium in the interest of attracting others to trade with them. The broker who is not a broker trader would not be able to provide the same countervailing element in the pit.

The broker trader in the third example effectively brought the information and interests signalled by other traders together with the information and interest signalled by his customer's order to negotiate an agreement that could give his customer a superior price. His only vehicle for negotiation is bidding and offering openly in the pit. He cannot secretly gather information from each of several other market participants separately and then put together a deal. Prearrangement is prohibited and the speed of pit trading generally makes extended negotiation totally impractical. However, by bidding and offering for various trades, the broker trader can effectively perform a negotiation that brings buyers and sellers together at a better price for his customer. This is the essence of the broker's function in any market.

These examples illustrate the fundamental mechanisms at play in the futures pit, as well as the role of broker traders in executing their customers' orders at the best possible price. There are many different interests, with many different trading perspectives and kinds of information present in the pit. A similarly diverse set of interests is present in other environments where broker negotiations take place. Consider real estate markets for example. Both the real estate markets and the futures or options pit process diverse information, permit compromises among competing interests and facilitate final transactions at acceptable terms. But negotiations regarding price of a soybean spread can be completed in a matter of seconds; real estate brokers perform the same function at a much slower pace through negotiations that can take months. The broker trader, through his efficient management of the information which the customer order brings into the pit and his negotiation by means of open (not hidden or prearranged) bids and offers with market interests which are competing with his customer, brings these interests together in the form of an agreed upon transaction price.

Appendix B

BROKER TRADERS AND MARKET LIQUIDITY

The Exchanges' staff have undertaken an analysis of the effects of the broker trader system on market liquidity. Only preliminary findings are reported at this time due to the time limitations of the CFTC request and the complexity of the issue. The Exchanges will be continuing their analysis and will present any significant findings from this research to the CFTC.

Data Overview

The Exchanges examined market activity for a 5-day period in the fourth quarter of 1988 -- October 3 to October 7. This week approximated the average fourth quarter volume for the three exchanges combined.

The CBOT chose the following markets for examination:

U.S. Treasury Bond Futures, Day Session
Wheat Futures
1,000 oz. Silver Futures

These contracts are the highest volume contract (T-Bonds), a medium volume contract (wheat) and a low volume contract (silver). They provide the ability to contrast activity in interest rate and agricultural futures contracts.

For its analysis the MACE chose:

U.S. Treasury Bond Futures
Wheat
Deutsche Mark

These contracts represent high, average and low volume contracts at the MACE.

Finally, CRCE is submitting its one contract -- Rough Rice. Table 1 shows the volume exhibited by each contract on the examined days and the average volume for each contract.

Data Analysis

For each trading session, all traders were identified based on the CFTC's definition; that is, a trader was identified as a broker trader if he executed a CTI1 plus a CTI2, CTI3 or CTI4 trade during the session.1/ Based on this definition all traders were

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1/ A CTI1 trade is a trade for one's own account, a CTI2 trade is for a clearing member's house account, a CTI3 is a trade for another member on the floor, or an account controlled by such other member and a CTI4 is a trade for any other type of customer.

TABLE I
VOLUMES OF EXAMINED CONTRACTS

	DATE:	10/03	10/04	10/05	10/06	10/07	AVERAGE
CBT							
	T-Bonds (Day)	255,889	163,188	313,543	164,632	450,763	**269,603**
	Wheat	9,707	20,183	12,212	19,602	16,751	**15,691**
	1000oz Silver	2,076	558	810	1,532	3,155	**1,626**
MACE							
	T-Bonds	4,269	3,017	4,720	2,695	7,759	**4,492**
	Wheat	387	850	1,263	1,122	435	**811**
	D-Mark	288	109	914	136	80	**305**
CRCE							
	Rough Rice	24	99	26	11	145	**61**

defined as broker traders or other traders and their activity was examined for five different time brackets for each trading session. Specifically, market activity was examined for the half-hour brackets with the lowest volume and the highest volume, the first five minutes of trading (open), the last five minutes of trading (close) and trading across the entire session.

Overview

An overview of the relationship of the broker trader to the market is provided by Table 2. This table shows an aggregated analysis of broker trader activity over all trading sessions in the examined week.

CBOT. For the examined CBOT contracts broker traders represented about 25% to 36% of the traders executing trades during a trading session. The highest concentration of broker traders was found in the silver contract where on average 36.4% of the traders were broker traders.2/ In contrast, broker traders constituted the smallest percentage of traders in T-Bonds (25.5%). In addition to constituting a significant portion of the trader population, broker traders account for a majority of the trades and volume in the CBOT contracts. Over the entire period, broker traders executed between 48% and 90% of all trades and volume in most of the contracts. Trades by broker traders as a percent of total trades varied from a high of 89.7% in silver to a low of 47.6% in the T-Bonds. Volume from broker traders as a percent of total volume varied from 86.9% in silver to 52.5% in the T-Bonds. These data indicate that broker traders are extremely important in the CBOT contracts.

As would be expected, volume exhibits the major role of broker traders when examined on the basis of CTI codes. Broker traders executed 25% to 80% of the CTI1 trades over the examined period. This percentage ranged from a low of 25.2% in T-Bonds to a high of 80.0% in silver. These CTI1 trades represent the speculative capital on the floor and are the cornerstone of the liquidity that futures markets provide. The market share of these trades held by broker traders is prima facie evidence of their integral role in the provision of futures market liquidity.

2/ Due to the use of percentages, wide swings are exhibited in the low volume contracts with few traders. For example, a one trader change in a 10 trader pit makes for a substantial swing. The maximum number of broker traders and all traders in the four lowest volume contracts were, as follows:

Contract	Maximum Number Broker Traders	Maximum Number All Traders
Silver	5	16
MACE Wheat	3	35
D-marks	5	23
Rice	3	8

TABLE 2
AGGREGATED WEEKLY VOLUME OCTOBER 3 - OCTOBER 7 1988 (AVE. VOLUME WEEK)

	%B-Ts/All			VOLUME					
	Traders	Trades	Volume	%B-Ts CTI1/ All B-Ts	% B-Ts CTI1/ All CTI1	%B-Ts CTI2/ All CTI2	%B-Ts CTI3/ All CTI3	%B-Ts CTI4/ All CTI4	%B-Ts CTI2,3,4/ All 2,3,4
CBOT									
T-Bonds	25.5	47.6	52.5	27.6	25.2	84.9	84.2	93.2	89.4
Wheat	26.5	75.5	73.1	36.9	55.3	80.1	83.2	93.7	90.1
Silver	36.4	89.7	86.9	30.1	80.0	99.9	85.3	97.6	90.3
MACE									
T Bonds	11.7	40.1	47.9	32.6	24.6	87.7	85.7	92.1	88.7
Wheat	7.4	40.4	26.6	18.7	8.2	0.9	14.3	88.2	54.5
D-mark	17.2	51.1	52.7	34.5	32.9	42.4	94.9	99.5	77.0
CRCE									
R.Rice	33.3	48.9	46.1	34.2	53.0	18.5	95.7	46.9	43.1

Broker traders dominate brokerage execution in these markets accounting for about of 90% of all brokered trades. The broker trader share of outside customer executions (CTI4) ranges from a low of 93.2% in T-Bonds to a high of 97.6% in silver. The broker trader share of executions for another member on the floor (CTI3) is comparable, ranging from 83.2% in wheat to 85.3% in silver. Broker traders' market share of clearing member house account executions (CTI2) ranges from 80.1% in wheat to 99.9% in silver.

MACE. For the examined MACE contracts broker traders represented about 7 to 17% of the traders executing trades during a trading session. The highest concentration of broker traders was found in the D-mark contract with an average of 17.2% of the traders being broker traders. In contrast, broker traders constituted the smallest percentage of traders in wheat with 7.4% being broker traders.3/

Despite constituting a minority of the trader population, the broker traders account for about half of the trades and volume in two of the MACE contracts, T-Bonds and D-marks, plus 40% and 27%, respectively, of that in wheat. The share of trade activity accounted for by broker traders varied from a high of 51.1% in D-marks to a low of 40.1% in T-Bonds. Broker traders' share of volume varied from a high of 52.7% in D-marks to a low of 26.6% in wheat. The low number of traders and their substantial volume indicate that broker traders are some of the largest traders in the MACE contracts.

Volume composition, when examined on the basis of CTI, illuminates the role of broker traders. Broker traders provided 8% to 33% of the CTI1 trades executed over the examined period. This percentage ranged from a low of 8.2% in wheat to a high of 32.9% in D-marks. These CTI1 trades by broker traders show a substantial contribution to futures market liquidity.

Broker traders dominate brokerage execution in these markets accounting for in excess of 75% of the brokered trades in the T-Bonds and D-marks. The broker trader share of outside customer executions (CTI4) ranges from a low of 88.2% in wheat to a high of 99.5% in D-marks. Broker traders' share of executions for another member on the floor (CTI3) is comparable in T-Bonds (85.7%) and D-marks (94.9%), but low in wheat (14.3%). Broker traders' market share of clearing member house account executions (CTI2) is at 87.7% in T-Bonds, at 42.4% in D-marks and an inexplicable 0.9% in wheat.

CRCE. In the CRCE's rough rice contract broker traders represented about 33% of the traders executing trades during a trading session.

3/ The difference between CBOT and MACE wheat has no ready explanation and needs further investigation.

These broker traders account for 48.9% of the trades and 46.1% of the volume in the rice contract. These data indicate that broker traders are a major component of the rice market. Broker traders provided 53% of the CTI1 trades executed over the examined period; that is, they represented half of the speculative capital on the floor. Broker traders market share of outside customer brokerage (CTI4) in the rice contract was comparable, accounting for almost 47% of the brokered trades. Broker traders' share of executions for other members (CTI3) was 95.7%. Finally, broker traders' market share of clearing member trading account executions (CTI2) is lower at 16.5%.

Contract Characteristics and Broker Traders

The relatively small sample size of examined contracts makes it difficult to readily discern relationships between contract characteristics, such as average volume and underlying commodity, and broker traders' activity. These relationships require further study; however, preliminary observations are as follows:

CBOT. The highest volume CBOT contract, T-Bonds, exhibited comparably high broker trader activity; however, wheat had the highest level of broker trader activity (Table 2). Our presumption is that the slightly lower activity in the T-Bonds relative to wheat is reflective of the importance of spreading in the wheat contract, as noted later.[4]

The low volume contract (silver) is a sustained low-volume contract that has a high overall level of broker trader activity that would seem necessary to sustain the contract. This deserves further research.

MACE. No clear pattern was seen in the MACE contracts. The high volume contract, T-Bonds, and the low volume contract, D-marks, exhibited similar patterns of broker trader activity. Wheat, the moderate volume contract, stood out as an anomaly especially in light of the CBOT wheat contract. This also deserves greater examination.

CRCE. The CRCE's rough rice is a low volume agricultural contract exhibiting a substantial market share by broker traders.

Bracket Analysis

Intra-day analysis of broker traders share of market activity is revealing as regards the role of the broker trader system. Four periods were examined for each trading session, as explained earlier, the low and high half hour bracket, and the first and last five minutes of trading.

4/ A preliminary examination of activity in the MMI futures contract shows substantially less broker trader participation. This is a subject for further investigation.

CBOT. Intra-day market activity for the three CBOT contracts -- T-Bonds, wheat and silver is shown in Tables 3 and 4.

The data indicate that the relative number of broker traders in the active pits increases substantially between high and low volume brackets. This variance is due to the different responsibilities of the broker trader as opposed to the pure trader. The broker trader has the responsibility to serve his customers. This responsibility means that the broker trader must be present in the pit at all times whether volume is high or low. In contrast, the pure trader is answerable only to himself. If the pure trader doesn't feel that volume warrants his presence in the pit at a particular point in time, he can leave. Since fewer profit opportunities are available in low volume periods, fewer pure traders are present. Also note that broker traders generally accounted for a higher proportion of the trading population during the close relative to the open, since they must be prepared to meet brokerage demand wheareas, pure traders are free to leave.

In wheat, there is little variation in the average share of volume executed by broker traders across the low, high and open; however, close volume share increases. In contrast, T-Bond broker traders have a greater share of volume at both the close and low relative to the open and high bracket. Observations on broker trader activity over all silver brackets is difficult due to low participation at times and absense of CTI1 volume at many times.

The importance of broker traders to liquidity in the low bracket is seen in T-Bonds and wheat. On average, broker trader CTI1 volume had its largest market share in wheat's low bracket providing 40.1% of the speculative capital and its second largest market share in T-Bonds' low bracket at 22.1%. Not only does their overall share increase at this time, but the intensity of their liquidity (CTI1) vs. brokerage (CTI2, 3 and 4) trade increases at this time to 27 and 33% of their trading activity in T-Bonds and wheat, respectively. These data lend evidence that, during periods of lower brokerage demand, broker traders execute relatively more personal trades, enhancing their contribution to market liquidity.

MACE. Intra-day market activity for the three MACE contracts -- T-Bonds, wheat and D-marks is shown in Tables 5 and 6. Please note that due to the low number of traders in these contracts, broker trader activity was not consistently observed.

The data indicate that the relative number of broker traders in the pits generally increases substantially between high and low volume brackets. This variance is again due to the different responsibilities of the broker trader as opposed to the pure trader, as explained above. In fact, MACE T-Bonds and wheat evidence this behavior even more strongly than the CBOT contracts.

In wheat, there was an increase in the share of volume accounted for by broker traders in the low and close brackets relative to the high and open. In contrast, T-Bond broker traders have their

TABLE 3: BRACKET ANALYSIS - CBT

DATE: T-Bonds	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
	Number of Broker Traders/Number of All Traders							
Low	39.2	37.1	38.4	38.6	37.8	38.2	39.2	37.1
High	32.9	28.8	34.4	31.0	30.5	31.5	34.4	28.8
Open-5	30.9	28.6	31.5	28.5	32.5	30.4	32.5	28.5
Close-5	55.2	41.4	66.7	66.7	62.5	58.5	66.7	41.4
	Broker Traders' Volume/All Volume							
Low	51.3	43.5	48.2	39.8	46.8	45.9	51.3	39.8
High	39.4	37.5	43.3	48.4	44.9	42.7	48.4	37.5
Open-5	35.5	31.5	36.2	34.3	45.1	36.5	45.1	31.5
Close-5	66.6	51.0	56.5	57.7	64.6	59.3	66.6	51.0
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low	23.4	21.7	20.5	21.7	23.3	22.1	23.4	20.5
High	12.3	12.5	16.1	18.8	16.4	15.2	18.8	12.3
Open-5	12.8	14.5	17.3	14.2	14.3	14.6	17.3	12.8
Close-5	35.4	6.7	13.0	42.1	28.6	25.2	42.1	6.7
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low	19.8	28.9	23.7	33.1	30.4	27.2	33.1	19.8
High	19.6	20.0	23.4	21.4	20.3	21.0	23.4	19.6
Open-5	25.5	35.9	33.0	28.5	18.2	28.2	35.9	18.2
Close-5	19.9	6.7	11.5	24.1	20.1	16.5	24.1	6.7

DATE: Wheat	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
	Number of Broker Traders/Number of All Traders							
Low	52.8	46.9	60.0	45.3	57.5	52.5	60.0	45.3
High	44.8	40.8	38.1	32.4	38.9	39.0	44.8	32.4
Open-5	48.1	50.0	40.0	39.6	45.8	44.7	50.0	39.6
Close-5	55.6	25.0	60.0	54.5	71.4	53.3	71.4	25.0
	Broker Traders' Volume/All Volume							
Low	67.4	54.6	67.9	44.9	72.3	61.4	72.3	44.9
High	64.5	65.6	53.2	55.8	67.6	61.3	67.6	53.2
Open-5	67.5	59.8	43.0	54.0	74.5	59.8	74.5	43.0
Close-5	69.5	41.0	75.0	58.9	84.8	65.8	84.8	41.0
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low	34.5	39.1	40.4	21.6	64.9	40.1	64.9	21.6
High	40.8	39.0	35.2	19.7	47.2	36.4	47.2	19.7
Open-5	44.8	46.6	29.0	24.0	54.3	39.7	54.3	24.0
Close-5	39.4	0.0	28.7	25.5	55.0	29.7	55.0	0.0
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low	21.0	43.0	26.7	21.4	52.5	33.0	52.5	21.0
High	30.7	23.7	37.5	15.9	34.0	28.4	37.5	15.9
Open-5	35.8	50.5	37.1	21.5	36.3	36.2	50.5	21.5
Close-5	31.3	0.0	28.1	22.4	18.8	20.1	31.3	0.0

Note: Blank cells are due to either no broker trader activity or no CTI1 trades by broker traders.

TABLE 4: BRACKET ANALYSIS - CBT

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
Silver	Number of Broker Traders/Number of All Traders							
Low		33.3		40.0	66.7	46.7	66.7	33.3
High	11.1		11.1	28.6	57.1	27.0	57.1	11.1
Open-5		25.0	14.3	60.0	66.7	41.5	66.7	14.3
Close-5	16.7			28.6	66.7	37.3	66.7	16.7
	Broker Traders' Volume/All Volume							
Low		10.5		40.0	81.8	44.1	81.8	10.5
High	5.3		2.3	3.2	71.1	20.5	71.1	2.3
Open-5		25.0	3.3	62.5	75.0	41.5	75.0	3.3
Close-5	5.5			4.4	75.0	28.3	75.0	4.4
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low		11.1		23.1	80.0	38.1	80.0	11.1
High	19.7			67.7	58.0	48.5	67.7	19.7
Open-5		33.3		76.9	66.7	59.0	76.9	33.3
Close-5	11.4			15.3	50.0	25.6	50.0	11.4
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low				37.5	88.9	63.2	88.9	37.5
High					24.8	24.8	24.8	24.8
Open-5		100.0		100.0	66.7	88.9	100.0	66.7
Close-5					33.3	33.3	33.3	33.3

Note: Blank cells are due to either no broker trader activity or no CTI1 trades by broker traders.

ABLE 5: BRACKET ANALYSIS - MACE

DATE:	10/03	10/04	10/05	10/06		VE.	MAX	MIN
T-Bonds	Number of Broker Traders/Numb					raders		
Low	35.7	36.4	50.0	28.6	[illegible]	[illegible]	50.0	21.6
High	16.5	16.7	19.4	17.9	16.8	[illegible]	19.4	16.5
Open-5	20.0	16.7	33.3	50.0	40.0	32.0	50.0	16.7
Close-5	50.0	41.7	44.4	42.9	44.4	44.7	50.0	41.7
	Broker Traders' Volume/All Volume							
Low	59.4	38.6	50.7	51.9	21.1	44.4	59.4	21.1
High	38.6	39.2	35.6	27.9	45.7	37.4	45.7	27.9
Open-5	13.2	22.2	23.3	50.0	34.0	28.5	50.0	13.2
Close-5	47.3	52.4	41.7	75.4	36.3	50.6	75.4	36.3
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low	4.0	29.7	15.0		3.0	12.9	29.7	3.0
High	16.6	6.0	7.5	4.0	8.6	8.5	16.6	4.0
Open-5	13.2		17.9	50.0		27.0	50.0	13.2
Close-5		47.4	16.7	3.3	2.6	17.5	47.4	2.6
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low	2.6	64.7	17.1		8.9	23.4	64.7	2.6
High	28.6	8.4	14.1	10.4	10.1	14.3	28.6	8.4
Open-5	100.0		71.4	100.0		90.5	100.0	71.4
Close-5		41.9	20.0	1.1	1.7	16.2	41.9	1.1

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
Wheat	Number of Broker Traders/Number of All Traders							
Low	33.3	50.0	22.2	33.3		34.7	50.0	22.2
High	9.1	11.1	20.0	14.3	10.0	12.9	20.0	9.1
Open-5	28.6	15.4	28.6	27.3	10.0	22.0	28.6	10.0
Close-5		33.3	25.0	22.2	50.0	32.6	50.0	22.2
	Broker Traders' Volume/All Volume							
Low	20.0	28.6	23.0	21.6		23.3	28.6	20.0
High	8.0	14.4	33.4	17.9	18.0	18.3	33.4	8.0
Open-5	30.0	15.7	25.0	18.3	14.0	20.6	30.0	14.0
Close-5		16.7	14.3	11.9	50.0	23.2	50.0	11.9
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low	5.9	16.7	24.5	13.8		15.2	24.5	5.9
High		1.9	5.9	5.3	3.7	4.2	5.9	1.9
Open-5	3.4	4.4	15.4	6.1	1.1	6.1	15.4	1.1
Close-5						0.0	0.0	0.0
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low	25.0	33.3	52.2	57.9		42.1	57.9	25.0
High		10.3	8.9	15.1	14.5	12.2	15.1	8.9
Open-5	8.3	21.4	54.5	26.7	5.3	23.2	54.5	5.3
Close-5						0.0	0.0	0.0

Note: Blank cells are due to either no broker trader activity or no CTI1 trades by broker traders.

TABLE 6: BRACKET ANALYSIS - MACE

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
D-Mark	Number of Broker Traders/Number of All Traders							
Low					50.0	50.0	50.0	50.0
High	35.7	25.0	44.4	50.0	12.5	33.5	50.0	12.5
Open-5	50.0	50.0		50.0		50.0	50.0	50.0
Close-5		33.3	50.0	25.0	50.0	39.6	50.0	25.0
	Broker Traders' Volume/All Volume							
Low					50.0	50.0	50.0	50.0
High	61.3	20.5	57.4	76.9	27.8	48.8	76.9	20.5
Open-5	50.0	50.0	100.0	50.0		62.5	100.0	50.0
Close-5		25.0	50.0	25.0	50.0	37.5	50.0	25.0
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low						0.0	0.0	0.0
High	53.2	18.2	73.8	62.5	12.0	43.9	73.8	12.0
Open-5			100.0			100.0	100.0	100.0
Close-5		50.0		33.3		41.7	50.0	33.3
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low						0.0	0.0	0.0
High	42.0	25.0	72.7	50.0	30.0	43.9	72.7	25.0
Open-5			50.0			50.0	50.0	50.0
Close-5		100.0		100.0		100.0	100.0	100.0

Note: Blank cells are due to either no broker trader activity or no CTI1 trades by broker traders.

greatest share of volume at the close relative to the other brackets.

CRCE. Intra-day market activity for rough rice is shown in Table 7. The data are difficult to intrepret due to the low number of traders and broker traders (see footnote 2).

Back Month Liquidity

Broker trading has been traditionally associated with the enhancement of back month liquidity due to broker traders' ability to "leg in" a spread (see Appendix A for an explanation of "legging"). As a preliminary examination, the composition of average back month activity for the week was examined with regard to broker trader executions.

CBOT. Wheat, T-bonds and silver which were examined for the CBOT have particular distinctions due to differences in the underlying cash market. Table 8 shows the aggregated weekly activity in wheat for each expiration. Wheat is a carrying charge market where intermonth spreads vary due not only to interest rates but storage charges, inventory demands, crop years, etc.. These multiple factors lead to substantial volatility in the price relationships between months. This spread volatility creates a hedge demand and a demand for brokerage services.

Table 8 shows that broker traders account for a substantial portion of the back month activity for the examined period. These data indicate that the broker trader is a major marketmaking force in these back months with regard to overall volume, accounting for up to 54%; speculative capital from the floor (CTI1 trades), generally providing 21% to 33%; and brokerage, providing up to 83%.

The wheat contract stands in stark contrast to contracts that exhibit less variable pricing relationships over time. For example, back month prices are determined almost exclusively by interest rates in the T-bond and silver markets; therefore, there is substantially less hedge demand for spread positions within the market. Rather back month demand for rollovers is reflected in first deferred month (intermarket spreads are a different matter and cannot be observed from these data.) This rollover demand and reduced spread demand is seen in the market activity data for these contracts (Table 9). There is activity in the first deferred expiration but very little or no broker trader activity in the further deferred months of these CBOT contracts.

MACE. Only MACE wheat was examined for back month liquidity from broker traders (Table 10). Although broker trader activity was substantially lower in MACE wheat relative to CBOT wheat, MACE wheat still exhibits a substantial contribution by broker traders to back month liquidity. Broker traders generally acccunt for 40% to 50% of the back month volume, 17% to 36% of the speculative capital provided to those back months (CTI1 trades) and 61% to 77%

TABLE 7: BRACKET ANALYSIS - CRCE

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
R. Rice	Number of Broker Traders/Number of All Traders							
Low							0.0	0.0
High		14.3	14.3		28.6	19.1	28.6	14.3
Open-5	50.0	50.0	50.0		50.0	50.0	50.0	50.0
Close-5					32.3	32.3	32.3	32.3
	Broker Traders' Volume/All Volume							
Low						0.0	0.0	0.0
High		9.5	9.5		18.0	12.3	18.0	9.5
Open-5	50.0	50.0	50.0		50.0	50.0	50.0	50.0
Close-5					47.6	47.6	47.6	47.6
	Broker Traders' CTI1 Volume/All CTI1 Volume							
Low						0.0	0.0	0.0
High		12.5	12.5		1.2	8.7	12.5	1.2
Open-5	50.0	69.2			50.0	56.4	69.2	50.0
Close-5						0.0	0.0	0.0
	Broker Traders' CTI1 Volume/All Broker Traders' Volume							
Low						0.0	0.0	0.0
High		8.3	50.0		2.6	20.3	50.0	2.6
Open-5	100.0	11.5			100.0	70.5	100.0	11.5
Close-5						0.0	0.0	0.0

Note: Blank cells are due to either no broker trader activity or no CTI1 trades by broker traders.

TABLE 6

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR CBOT WHEAT CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CTI1 SHARE OF ALL CTI1 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CTI2,3,4) VOLUME	BROKER-TRDR CTI1 SHARE OF ALL BROKER-TRDR VOLUME
CBOT				
10/3-10/7				
DEC '88	72%	53%	88%	35%
MAR '89	54%	31%	83%	31%
MAY '89	44%	21%	65%	24%
JUL '89	51%	30%	77%	32%
SEP '89	25%	33%	20%	50%
DEC '89	0%	0%	0%	0%

TABLE 9

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER TRADERS FOR CBOT T-BONDS AND 1000 OZ. SILVER CONTRACTS

WEEK-LONG AVERAGES FOR
WEEK OF OCTOBER 3 THROUGH 7

CBOT T-BONDS CONTRACT:	BROKER TRDR SHARE OF ALL VOLUME	BROKER TRDR CTI1 SHARE OF ALL CTI1 VOLUME	BROKER TRDR SHARE OF ALL BROKERAGE (CTI2,3,4) VOLUME	BROKER TRDR CTI1 SHARE OF ALL BROKER TRDR VOLUME
DEC '88	52%	24%	89%	27%
MAR '89	26%	9%	38%	14%
JUNE '89	12%	7%	17%	26%
SEP '89	4%	0%	2%	12%
DEC '89	8%	4%	14%	29%
MAR '90	0%	0%	0%	0%
JUN '90	0%	0%	0%	0%
SEP '90	0%	0%	0%	0%
DEC '90	5%	4%	5%	42%
MAR '91	0%	0%	0%	0%
JUN '91	0%	0%	0%	0%
CBOT SILVER*				
DEC '88	87%	79%	90%	29%
FEB '89	22%	34%	1%	98%
APRIL '89	0%	0%	0%	0%
JUNE '89	0%	0%	0%	0%

* OCT '88 Deleted as delivery month.

TABLE 10

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR MACE WHEAT CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CTI1 SHARE OF ALL CTI1 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CTI2,3,4) VOLUME	BROKER-TRDR CTI1 SHARE OF ALL BROKER-TRDR VOLUME
MACE				
10/3-10/7				
DEC '88	23%	4%	52%	10%
MAR '89	48%	20%	77%	21%
MAY '89	50%	36%	61%	33%
JULY '89	40%	17%	69%	23%
SEP '89	0%	0%	0%	0%

of the brokerage activity in these back months. Again note that the differences between the MACE and CBOT wheat markets bear further investigation. Also low volume in this market has a strong effect on these results.

CRCE. The rough rice market is similar in nature to the wheat markets and the back month contribution of broker traders is strong. Table 11 illustrates the contribution of the broker trader to back month liquidity in rice. The broker trader accounts for up to 40% of back month volume, 33 to 60% of the speculative capital (CTI1 trades) in those back months and up to 43% of back month brokerage. Again, these percentages are extremely volatile due to low volume.

Low and High Volume Days

CBOT. Broker trader activity for the nearby months of CBOT T-bonds, wheat and silver on the lowest and highest volume day of the week is shown on Tables 12, 13 and 14.

T-bond volume was lowest on October 4 and highest on October 7 (Table 12). As expected on the high volume day there was a larger trading population with more broker traders relative to the low volume day. Broker traders executed a larger proportion of all volume on the high volume day (49.6% vs. 41.8%). This increase in broker trader volume share occurred as, on average, each broker trader executed more than double the volume they did on the slower day with more and larger trades. On both days broker traders executed about one-third of their trades for their own accounts. For each customer category (CTI2 through 4), broker traders executed a slightly larger proportion of all trades on the high volume day relative to the low volume day as customers requested additional brokerage services.

Wheat volume was lowest on October 3 and highest on October 4 (Table 13). The number of all traders and the number of traders classified as broker traders on the high volume day were slightly higher than that of the low volume day. The share of all volume executed by broker traders on the high volume day was greater as each broker trader did more trades and larger trades. On the high volume day a slightly larger proportion of all customer trades (CTI2,3,4) were executed by broker traders. However, while broker traders did a larger share of CTI2 customers volume on the busy day, they did a smaller share of CTI3 and 4 volume on the busy day. Broker traders' share of CTI1 volume was about the same on both days. The ratios indicate that on the low volume day in wheat a greater percentage of broker trader activity was comprised of trading for their own account.

Daily volume in the relatively slow 1000 oz. silver contract can vary widely. While the total number of traders on the high volume day was just above that of the low volume day, the number of broker traders rose from one to five (Table 14). The share of all volume executed by broker traders on the high volume day was far greater than that of the low volume day. Volume and trades per

TABLE 11

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR CRCE ROUGH RICE CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CTI1 SHARE OF ALL CTI1 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CTI2,3,4) VOLUME	BROKER-TRDR CTI1 SHARE OF ALL BROKER-TRDR VOLUME
CRCE				
10/3-10/7				
NOV '88	45%	47%	45%	28%
JAN '89	40%	60%	32%	42%
MAR '89	38%	33%	43%	42%

TABLE 12

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

CBOT T-BONDS DECEMBER EXPIRATION	LOW DAY: OCT 4	HIGH DAY: OCT 7
TOTAL VOLUME (all expirations)	163,188	450,763
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	644	693
NUMBER BROKER TRADERS	141	162
BROKER TRADERS/TOTAL TRDRS	21.9%	23.4%
BROKER TRADERS ONLY:		
NUMBER BROKER TRADERS	41.8%	49.6%
VOLUME PER TRADER	478	1273
TRADES PER TRADER	43	81
VOLUME PER TRADE	11.2	15.7
CTI1 TRADES/ALL TRADES	38.4%	36.0%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	78.1%	82.5%
B-T CTI1 VOLUME/ALL B-T VOLUME	21.7%	24.3%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	15.7%	21.3%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	68.5%	82.8%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	73.2%	77.0%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	84.5%	90.9%

TABLE 13

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

CBOT WHEAT
DECEMBER EXPIRATION

	LOW DAY: OCT 3	HIGH DAY: OCT 4
TOTAL VOLUME (all expirations)	9,707	20,183
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	69	88
NUMBER BROKER TRADERS	19	24
BROKER TRADERS/TOTAL TRDRS	27.5%	27.3%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	65.1%	67.6%
VOLUME PER TRADER	256.9	447.4
TRADES PER TRADER	62.1	91.8
VOLUME PER TRADE	4.1	4.9
CTI1 TRADES/ALLTRADES	27.3%	25.2%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	91.6%	92.3%
B-T CTI1 VOLUME/ALL B-T VOLUME	28.7%	28.1%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	38.6%	42.8%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	55.2%	91.2%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	80.8%	74.6%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	96.1%	89.1%

TABLE 14

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

CBOT SILVER
DECEMBER EXPIRATION

	LOW DAY: OCT 4	HIGH DAY: OCT 7
TOTAL VOLUME (all expirations)	558	3,155
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	11	13
NUMBER BROKER TRADERS	1	5
BROKER TRADERS/TOTAL TRDRS	9.1%	38.5%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	4.9%	81.4%
VOLUME PER TRADER	23	507.5
TRADES PER TRADER	8	37
VOLUME PER TRADE	2.9	13.7
CTI1 TRADES/ALLTRADES	82.4%	37.3%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	1.4%	92.8%
B-T CTI1 VOLUME/ALL B-T VOLUME	54.3%	29.1%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	6.4%	70.9%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	n.a.	41.6%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	12.3%	94.8%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	0.3%	91.8%

broker trader were also much higher on the high volume day. The ratio of broker trader CTI1 volume to volume executed by broker traders for customers was much smaller on the high volume day. Broker traders' share of all CTI2, CTI3 and CTI4 volume was also much higher on the high volume day.

MACE. Tables 15, 16 and 17 show several measures of broker trader activity for nearby months on the low and high volume day for MACE T-bond, wheat, and D-mark futures.

T-bond volume was lowest on October 6 and highest on October 7 (Table 15). There were 40% more traders trading T-bonds on the high volume day and 57% more broker traders on that day than on the low volume day. The volume and number of trades per broker trader were much higher on the high volume day, but broker traders executed a nearly identical proportion of all volume on both days. On both days broker traders executed around one-third as many trades for their own accounts as they did for other customers. Except for the increase in CTI2 volume on the high volume day, broker traders executed similar proportions of all customer volume on the two days.

Wheat volume was lowest on October 3 and highest on October 5 (Table 16). While the number of all traders and broker traders was lower on the high volume day, broker traders' share of all volume on the high volume day was nearly double that of the low volume day. Again, this occurred as broker traders executed more trades and larger trades. While broker traders' CTI1 volume as a fraction of all broker trader volume was lower on the high volume day, their share of all CTI1 volume was higher. Brokers traders executed a smaller proportion of all brokerage volume on the high volume day.

Volume in the MACE D-mark contract on the high volume day was more than [illegible] times that of the low volume day (Table 17). The total number of traders and number of broker traders on the high volume day increased by four and three, respectively, from the low volume day. The share of all volume executed by broker traders rose from 14.4 to 27.0% across these days. Volume and trades per broker trader were much higher on the high volume day. On the high volume day the proportion of CTI2 and CTI3 trades that were executed by broker traders increased substantially. However, CTI4 executions by broker traders declined. The ratio of broker trader CTI1 volume to all volume executed by broker traders increased from 17.4 to 62.7%. Broker traders executed a larger share of CTI1 volume on the high volume day.

CRCE. Table 18 shows various measures of broker trader activity in the nearby month of the CRCE Rough Rice contract. No broker traders were active on either the high or low volume day.

Conclusions

We have presented our preliminary observations on broker trader activity and liquidity. None of our findings are conclusive and

TABLE 15

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

MACE T-BONDS
DECEMBER EXPIRATION

	LOW DAY: OCT 6	HIGH DAY: OCT 7
TOTAL VOLUME (all expirations)	2,695	7,759
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	156	219
NUMBER BROKER TRADERS	14	22
BROKER TRADERS/TOTAL TRDRS	9.0%	10.0%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	37.3%	38.4%
VOLUME PER TRADER	70.6	134.2
TRADES PER TRADER	25.2	34.52
VOLUME PER TRADE	2.8	3.89
CTI1 TRADES/ALLTRADES	23.9%	26.0%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	80.5%	80.8%
B-T CTI1 VOLUME/ALL B-T VOLUME	14.4%	19.5%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	9.2%	12.1%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	60.7%	75.5%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	76.3%	79.2%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	84.7%	84.5%

TABLE 16

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

MACE WHEAT DECEMBER EXPIRATION	LOW DAY: OCT 3	HIGH DAY: OCT 5
TOTAL VOLUME (all expirations)	387	1,263
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	26	22
NUMBER BROKER TRADERS	3	2
BROKER TRADERS/TOTAL TRDRS	11.5%	9.1%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	16.7%	30.6%
VOLUME PER TRADER	20.2	180.2
TRADES PER TRADER	11.5	61.5
VOLUME PER TRADE	1.8	5.9
CTI1 TRADES/ALL TRADES	23.2%	23.6%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	84.1%	61.4%
B-T CTI1 VOLUME/ALL B-T VOLUME	17.4%	11.8%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	3.7%	7.3%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	0.0%	0.0%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	50.0%	2.1%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	95.9%	72.4%

TABLE 17

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

MACE DEUTSCHE MARKS DECEMBER EXPIRATION	LOW DAY: OCT 7	HIGH DAY: OCT 5
TOTAL VOLUME (all expirations)	80	914
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	19	23
NUMBER BROKER TRADERS	1	4
BROKER TRADERS/TOTAL TRDRS	5.3%	17.4%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	14.4%	27.0%
VOLUME PER TRADER	11.5	61.6
TRADES PER TRADER	11.5	19.1
VOLUME PER TRADE	1	3.2
CTI1 TRADES/ALLTRADES	17.4%	52.9%
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	28.4%	21.7%
B-T CTI1 VOLUME/ALL B-T VOLUME	17.4%	62.7%
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	4.3%	31.5%
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	0.0%	44.4%
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	33.3%	50.0%
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	42.5%	7.3%

TABLE 18

COMPARISON OF BROKER-TRADER ACTIVITY ON HIGHEST AND LOWEST VOLUME DAYS

CRCE ROUGH RICE
NOVEMBER EXPIRATION

	LOW DAY: OCT 6	HIGH DAY: OCT 7
TOTAL VOLUME (all expirations)	11	145
NOVEMBER CONTRACT ONLY:		
TOTAL TRADERS	5	7
NUMBER BROKER TRADERS	0	0
BROKER TRADERS/TOTAL TRDRS	n.a.	n.a.
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	n.a.	n.a.
VOLUME PER TRADER	n.a.	n.a.
TRADES PER TRADER	n.a.	n.a.
VOLUME PER TRADE	n.a.	n.a.
CTI1 TRADES/ALL TRADES	n.a.	n.a.
B-T CTI2,3,4 TRADES/ALL CTI2,3,4 TRADE	n.a.	n.a.
B-T CTI1 VOLUME/ALL B-T VOLUME	n.a.	n.a.
B-T CTI1 VOLUME/TOTAL CTI1 VOLUME	n.a.	n.a.
B-T CTI2 VOLUME/TOTAL CTI2 VOLUME	n.a.	n.a.
B-T CTI3 VOLUME/TOTAL CTI3 VOLUME	n.a.	n.a.
B-T CTI4 VOLUME/TOTAL CTI4 VOLUME	n.a.	n.a.

much more research is needed for a definative picture of the complex relationships between broker trader activity and market liquidity. Nevertheless, our preliminary work leads to several tentative conclusions as follows:

a. Broker traders account for a major if not the major share of futures market activity.

b. The broker traders provide a substantial amount of the speculative capital on the floor of the exchanges. This is true in almost all nearby expirations.

c. Some variation in broker trader activity is seen across markets based on their underlying commodity. Broker trader activity is greatest in the agricultural contracts and slightly less in the interest rate complex.

d. Broker traders make a substantial contribution to market liquidity in low volume periods as they increase their own trading during periods of slack brokerage demand.

e. Broker traders are a major force supplying back month brokerage and liquidity in markets with volatile spread relationships.

f. Dramatic variations in volume and demand for brokerage are observed across commodity and through time. This is associated with a large but widely varying amount of broker trading.

In general, the broker trader plays a critical role in contract activity across all three exchanges. A role that will be fully understood only with further research.

Appendix C

Appendix C: Letters from Market Users

-C1-

FEB 06 1989

CARGILL

1000 La Salle Bank Bldg.
135 South La Salle Street
Chicago, Illinois 60603

February 6, 1989

TO: KARSTEN MAHLMANN
CHAIRMAN OF THE BOARD
CHICAGO BOARD OF TRADE

FROM: PETER VON ESCHEN
FUTURES FLOOR MANAGER
CARGILL, INCORPORATED

SUBJECT: DUAL TRADING

Dear Cash:

The broker/trader has provided the users of the Commodity Markets with better executions at lower cost for many years. Therefore, we believe that to discard dual trading would adversely affect the efficiency of the marketplace.

Perhaps the classification of each broker as a "broker" or "broker/trader" would be a reasonable compromise. It would enable each clearing firm to use this information in the selection of the brokers that it wished to use.

This issue is of such importance to both members and customers that it deserves to be determined by the measured response as advocated at last Tuesday's floor meeting.

Finally, to outlaw dual trading before any charges have been made, even before the investigation is admitted by the authorities, might convey to the watching public a sense of guilt by the Chicago Board of Trade. That would indeed be unfortunate for all of us.

Furthermore, we feel that this exchange has regulations in place today, that if enforced rigorously, can guard against any potential abuses of dual trading.

Yours very truly,

Peter Von Eschen

Peter A. Von Eschen
Manager - Floor Operations
Cargill, Incorporated

PV/dcb

-C2-

FEB 06 1989

Barnes & Co.
MEMBERS OF ALL PRINCIPAL FUTURES EXCHANGES

February 6, 1989

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

The undersigned would like to express our strong opposition to proposed changes in dual trading. We believe that our clients benefit greatly from the flexibility that dual trading offers. We are particularly concerned that we will not be able to "leg" spreads, and that with brokers not being able to keep the spreads in line the difference between the bid and ask will grow to the detriment of all who use the Board of Trade for risk transfer. We also believe that volume over all will drop by over 10 percent.

The Board of Directors handling of these matters appears to be inconsistent at best. On one hand the Board of Directors refuses to answer allegations in the press - on the other hand they propose to change an age old practice specifically because of these allegations. It appears to us that dual trading is being offered as a sacrificial lamb to appease Congress and others.

The main argument against dual trading appears to be that the temptation is too great to steal. In that case the banks should get rid of all bank tellers because of the temptation.

As a self-regulatory body we must do the job stringently, and weed out the bad apples ourselves. If we now try to placate, and ban dual trading, it is tantamount to admitting that we can't handle the job ourselves - and that the practice has led to widespread abuse all along.

141 WEST JACKSON BOULEVARD.
SUITE 221A, CHICAGO ILLINOIS 60604
[illegible]

Page 2 of 2
Mr. Mahlmann

As a group with years of experience in several pits we do not believe that dual trading has lead to widespread abuse. On the contrary our clients are proud of our integrity, and we are proud of the integrity of our fellow members.

Yours truly,

John N. Macintosh
John N. Macintosh

Matthew Connelly
Matthew J. Connelly

Dale E Lorenzen
Dale E. Lorenzen

Thomas S Law
Thomas S. Law

S Hal Phillips
S. Hal Phillips

give the customers the option to direct their orders to other brokers. Also, the exchange should regularly and randomly audit brokers via the CTR system and any other methods available.

Sincerely,

Daniel F Brophy

Daniel F. Brophy

-C4-

FEB 1

1701 N. North Park, #2
Chicago, Illinois 60614
February 6, 1989

Mr. Tom Donovan
President
The Chicago Board of Trade
141 W. Jackson Blvd.
Chicago, IL 60604

Dear Mr. Donovan:

I am a local trader and owner of a full membership at the board of Trade. I do not fill customer orders in the pits, but I do handle customer orders, from commercial firms, for commissions (off-floor).

I speak for myself and for my customers in stating that it is a mistake and a disservice to customers to ban dual trading.

To put the argument simply, if dual trading is banned, no broker will dare take the financial risk to execute a spread order by "legging" the order, i.e. by buying on month's futures contract outright in the market, and selling another oughtright in the market.

This will force brokers to rely strictly on local traders for spread quotes and spread execution, or to depend on another broker fortuitously having the opposing spread to execute on another order. The good brokers know how to judge whether a local's offer is on the market, and if they judge that it is not, they can go into the market with outright trading ("legging"), actually competing with the local instead of depending on him, to complete the order.

Unfortunately, it is difficult for the average person to understand this subtlety. But eliminating dual trading will also eliminate a source of competition for the locals that makes the market more honest and increases liquidity.

I heard a worthwhile suggestion to alleviate customers' doubts about dual trading. All brokers who trade for themselves should register the fact with the exchange and with every clearing firm with whom they do business. The clearing firms should notify customers that these brokers intend to trade for themselves, and

-C6-

SOUTHERN FARMERS ASSOCIATION
824 North Palm Street • North Little Rock, Arkansas 72119

March 15, 1989

Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL. 60604

Dear Mr. Mahlmann:

The success of any business depends on it's credibility. I understand that any abuses to trading rules must be detected and eliminated at the Chicago Board of Trade and other futures markets. However, these abuses, if they occur, need to be corrected in a manner that does not decrease the flexibility of trading that we currently experience.

I understand that there has been a move to eliminate dual trading for pit traders. I understand, as an agent for a commercial feed and grain operation. that taking away this ability from traders will decrease my flexibility, increase my cost and lower the overall liquidity of the market.

I want my broker to have all the tools necessary to execute my orders swiftly and efficiently. I would appreciate you letting my feelings on this matter be known to those making policy for the industry.

Sincerely,

Scott Hardy

Scott Hardy
Southern Farmers Association

-C7-

CENTRAL LOUISIANA GRAIN CO-OP, INC.
P.O. BOX 748
BOYCE, LOUISIANA 71409

March 15, 1989

Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann:

Due to the recent trading abuses at the Chicago Board of Trade I urge you to consider the following two points.

1. The need to try to detect and eliminate trading abuses at the Board of Trade as quickly as possible, and
2. Urge that they do not give up the dual trading ability of the traders in the pit.

I appreciate your support.

Sincerely,

John P. O'Neill Jr.

John P. O'Neill, Jr.
Manager.

Danny J. Brown

TREASURER/GENERAL MANAGER
MCCOY FARM SERVICE CENTER, INC.
DAVISBORO, GEORGIA

3-13-1989

Mr. Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson St.
6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann:

In the recent months a growing concern has arose from the reported trading abuses at the Chicago Board of Trade. We urge you to try to detect and elimate these trading abuses, but not at the expense of giving up the ability of dual trading by the floor traders. We feel that the service provided to the grain industry via dual trading is an asset to us and that some other form of restraints should be implemented to stop the trading abuses.

Sincerely,

Danny J. Brown
President, MFSC, Inc.

DJB/

-C9-

BARLEY
OATS

WHEAT
SOYBEANS

Phone
704-474-4103

C. E. McSWAIN & SONS, INC.

Route 1, Box 257
Norwood, N. C. 28128

March 16, 1989

Karsten Mahlmann
Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann,

It has recently come to my attention that the government, in its investigation of the CBOT concerning trading abuses, is considering elimination of dual trading pit brokers. I strongly support the need to detect and stop trading abuse at the CBOT as soon as possible. However, the ability for pit brokers to engage in dual trading is an extremely efficient mechanism for executing spread orders. We as country elevators use the spreads to set the market structure for our merchandising programs.

I urge you to use any influence that you have in behalf of the dual trading issue.

Sincerely,

Tim Lowre

Tim Lowry, Merchandiser
C.E. McSwain & Sons, Inc.

TL/sb

-C10-

FARMERS MILL AND ELEVATOR CO., INC.
DEXTER SUPPLY COMPANY
P. O. BOX 86 – PHONE 912-875-3107
DEXTER, GEORGIA 31019

Established 1952
"Service and Supply in Agriculture"

D W KNIGHT JR
HAROLD DAILY VICE

March 14, 1989

Karsten Mahlmann
Chairman
Chicago Board of Trade
141 W. Jackson, 6 th Floor
Chicago, IL 60604

RE: DUAL TRADING

Dear Mr. Mahlmann:

It has come to our attention that the government is trying to eliminate dual trading on the CBOT. We have read the reports of abuse by some traders and feel that those who fall into this category should be weeded out. It is our theory that in a democratic society such as ours that the majority should not have to suffer for the actions of a few.

We are engaged in an agri-business, which includes not only the supply of agriculture needs but also provides a market for their crops. Therefore, grain trading , hedging and contracting by means of orders to sell placed with our broker are a vital part of our business. Anything that may interfere with the freedom to efficiently handle these type transactions could very broad effects on the trade industry as a whole.

In a nut shell, we support the effort to find and eliminate abuses on the CBOT, but we strongly uphold the dual trading ability of traders in the pit.

Sincerely,

Harold Daily

Harold Daily, V.P.
and General Manager

HD:cjr

-C11-

3/15/89.

KARSTEN MAHLMANN
CHICAGO BOARD OF TRADE
141 W. JACKSON 6 FLOOR
CHICAGO. ILL. 60604

MR. MAHLMANN.

I DO NOT HAVE A PROBLEM WITH BROKERS BEING ABLE TO DUAL TRADE.

IN MY OPONION A BROKER BEING ABLE TO TRADE ON HIS BEHALF AND MINE INCREASES LIQUIDITY AND REDUCES VOLATILITY.

WE WILL NEVER PREVENT A CROOK FROM ENTERING ANY ASPECT OF BUSINESS. THEY MANAGE TO GET INTO PRIVATE AND PUBLIC BUSINESS AS WASHINGTON CAN ATTEST TO.

THE IMPORTANT THING IS THE SYSTEM WORKS AND A PERSON WHO DOES NOT OPERATE WITHIN THE SYSTEM DOES NOT LAST.

SINCERELY,

Ernie J. Peterson

ERNIE PETERSON
C.F.S.
BOX 24
CASHTON . WI 54619

Phone (414) 723-

Millard Feed Mill, Inc.

Feeds • Fertilizers • Grains • Grass Seeds • Seed Corn
Shelling • Mixing • Portable Mill
Hardware • Hay Equipment

Route 2, Box 192 - A :: Elkhorn, Wisconsin

March 14, 1989

Mr. Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, Illinois 60604

Dear Mr. Mahlmann:

I strongly support the Chicago Board of Trade to detect and eliminate the abuses as quickly as possible and urge that the dual trading ability of the traders in the pit not be eliminated. They need this flexibility to be able to trade for us.

Sincerely,

Earl J. Cook

Earl J. Cook
President
Millard'Feed Mill, Inc.

-C13-

LAWNDALE GRAIN, INC.
PHONE (217) 732-7356
LAWNDALE, ILLINOIS 61751

March 15, 1989

Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann,

We support your efforts in the need to try to detect and eliminate trading abuses at the Board of Trade as quickly as possible, and We urge that they do not give up the dual trading ability of the traders in the pit.

Respectfully yours,
James E. Hill, Mgr.
Lawndale Grain, Inc.

-C14-

ROCHE MANUFACTURING CO.

SPREADER SERVICE
HIGH GRADE FERTILIZERS
LIQUID NITROGEN

Phone (912) 864-2206
411 EAST COURT STREET
WRIGHTSVILLE, GEORGIA 31096

March 13. 1989

Mr. Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, Il. 60604

Dear Mr. Mahlmann:

We urge you to delete and eliminate trading abuses at the Chicago Board of Trade.

We also urge you not to give up the dual trading ability of the traders in the pit.

This could have a great impact on our business here in Georgia.

Yours very truly,

R. W. Williams
V.P. and Manager

RWW:nl

-C15-

February 8, 1989

Gordon P. Rule Brokerage Co., Inc
832 Judson Manor
St Louis, Mo. 63141

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board Of Trade
Chicago, Ill. 60604

I am a cash grain broker and occasional futures speculator who would like to comment on the proposal to ban dual trading. I believe the proposal would hamper liquidity and raise transaction costs. These negative effects would in turn hinder my own business since cash grain business volume hinges on all parts of the marketing process working efficiently.

I would advocate to maintain the present system which has been satisfactory to both myself and my customers.

Sincerely,

Gordon P. Rule

Drexel Burnham Lambert

FEB 13

Drexel Burnham Lambert Incorporated
3495 Piedmont Road
11 Piedmont Center
Atlanta, GA 30305-1738
404 231-1411

February 8, 1989

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, IL 60604

Dear Cash:

I fervently hope the Chicago Board of Trade will not seek or be coerced into eliminating "dual trading" as a membership right. The consequences in terms of lost liquidity alone would be disastrous, not to mention the obvious infringement upon rights of membership, to trade as well as to regulate itself.

While this suggestion has no doubt already been made, I would like to propose that the Board consider the merits of a practice Jerry Manne used many years ago when he was in a position to execute orders both for customers and for himself: that a member clear his own trades through a different house than that which handles his customer business. It is simple and reliable, like most of the practices which have made the futures industry unique in the financial investment world.

Again, my very best to you in your leadership. You have certainly happened in on interesting, and perhaps history-making, times, and the Board and the futures markets in general will, I believe, be the beneficiaries of your presence.

Kindest regards,

Carole

Carole S. Jacobsen
CSJ/scc

FEB 1

BENSON-QUINN CO.
1075 Grain Exchange
Minneapolis, Minn. 55415

February 7, 1989

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

This letter is to express opposition to the proposed changes in dual trading. Our company uses the CBOT to hedge risk in its cash grain trading operation. Market liquiditiy and volatility are constant factors in our risk management. Other factors in our risk management are honesty and integrity in our brokers. I hope the CBOT does not confuse the two issues and deprive me as a principle of the one item that I can make decisions about, ie. honesty and integrity; and deny me the issues about which I have no control, ie. liquidity and volatility.

Dual trading has, if properly surveyed, enhanced volume and price execution of orders. We hope that the CBOT is not so intense on giving the media something of a regulatory nature that they act in a irresponsible fashion in protecting the cornerstones of the market, its members, and its customers.

Sincerely,

BENSON QUINN COMPANY

L.N. Neumann
Vice Chairman & COO

FEB 10

February 8, 1989

E. Davison Massey
133 Chestnut Street
Winnetka, Ill. 60093

Mr. Karsten Mahlmann
Chairman
Chicago Board of Trade
141 W. Jackson Blvd.
Chicago, Illinois 60604

Dear Mahlmann:

I have read with interest over the past two weeks the very shrill newspaper coverage of the federal investigation of alleged improper trade practices at the Chicago Board of Trade. The various articles, particularly those of the Chicago Tribune, unfortunately read as a indictment of not only the membership of the Board of Trade as a whole but the futures markets in general. These allegations and innuendoes belie the long history of service which futures markets have provided for agriculture and other sectors of the U.S. economy. It is inconceivable to think that the possibility of wrongdoing on the part of a few people implies a condemnation of an entire industry and its members.

Aside from the intensity of the trial by press I am extremely concerned about the possibility of such rule changes as the prohibition of dual trading. This little understood practice promotes healthy competition in the market and allows brokers the flexibility of obtaining the best execution of orders entering the market. Prohibiting dual trading would,likely result in less competition, the reduced quality of execution and higher brokerage rates. The Board of Trade has functioned efficiently and faithfully for many more than 100 years and therefore to change the rules as a result of what seems to be a newspaper campaign on the part of an ambitious politician in the person of the federal prosecutor would not be keeping faith with the industry or the public which the markets serve.

Sincerely,

E. Davison Massey

E. Davison Massey

-C19-

FEB 08 1989

REIFF
GRAIN & FEED

HIGHWAY #1 NORTH
POST OFFICE BOX 881
FAIRFIELD, IOWA 52556

FAX 515 472 9229
[redacted] WATS 800-622-8225
TELEPHONE 515-472-4136

February 6,1989

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 W. Jackson
Chicago Illinois, 60604

Dear Mr. Mahlmann,

It is with great interest that we small country elevator operations in Iowa watch the current trading investigations into alledged trade abuses at the Board of Trade. We commend strict censure of any criminal acts that can be substantially proven, but would be extremely concerned if any changes in current practice be implemented to "fix" the order system we now have. After converting well over $100 million of Iowa producer grain using a hedge program the past 12 years, I'd have to say we have a great deal of confidance and reliance in the current system. It is rare when we question a "fill," and usually it's in a very fast market, or otherwise understandable. I also believe very strongly that dual trading must never be banned, as lots of market liquidity and spread activity would be lost, and therefore certainly raise the cost of the transaction to my customer.

Thank you for listening to my concerns;if I can be of any further assistance please do not hesitate to call at the numbers above.

Sincerely yours,

David S. Reiff, Pres.
Reiff Grain & Feed, Inc.
DSR:kg

MITSUBISHI INTERNATIONAL CORPORATION

CABLE ADDRESS:
MITSUBISHI NEWYORK

520 MADISON AVENUE
NEW YORK, N.Y. 10022

TELEPHONE:
(212) 605-2000

DATE February 08, 1989

OUR REF. No.

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

We, at Mitsubishi, would like to express our opposition to the proposed changes regarding dual trading. If it is the intent of the Board of Directors to root out stealing in the pits, then doing away with dual trading will not achieve that goal.

We believe that it is the customer that will suffer if dual trading is done away with. Firstly, the quality of the executions will deteriorate, especially with spreads. The fact that brokers will not be able to leg spreads will result in Spreads being thrown out of line and the difference between the bid and ask will grow. The spreads will become distorted and will certainly hurt those who use the Board of Trade. Secondly, this proposed change will cause good brokers to either leave the pits altogether or limit their trading to their own account. Therefore, there will be a shortage of good brokers handling customer orders. Thirdly, the shortage of brokers will increase the cost of doing business in the pits and as a result, the customer's cost will also rise.

Therefore, we do not believe that dual trading has lead to widespread cheating. We do believe that our brokers are of the highest integrity.

Yours truly,
Mitsubishi International Corporation

Ted Minagawa, Manager, Soy Complex
Foods "A" Division

FEB- 7-89 TUE 17:33 DM GRAIN C21-

DES MOINES GRAIN CO. -
Cash Grain Merchants
5731 URBANDALE AVE., SUITE #10
DES MOINES, IOWA 50310

Tim Asper
Jay R. Eliason

Carl E. Schumac
Kent H. Krce

FEB 08 1989

MR. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

The owners of Des Moines Grain Co. would like to express our strong opposition to the proposed changes in dual trading. We believe the elimination of dual trading would reduce the liquidity of the market. We believe the cost of reduced liquidation to the market will far exceed any perceived losses from bucket trades or other problems highlighted during the investigation. We rely heavily on the CBOT for timely risk transfer in our merchandising activities.

People, such as ourselves, who are not there to trade our own orders rely on the integrity of the brokerage firm we are using and have the ability to change firms if we feel our orders are not being handled properly. When we place a "market" order we understand the risks in placing that order. If we were unable to moniter activity on the screen we would rely on the broker we are paying the commision to perform that function.

Overall, we feel very strongly that the whole market should not be punished for what appears to be the actions of a relatively small percentage of the traders. There are many other areas of the political and business world that the same effort by the State's Attorney would generate more significant prosecutions.

We urge you to not act with haste when the significance of the problem has not been adequately identified.

Sincerely,
DES MOINES GRAIN CO.

Carl Schumacher

Carl Schumacher, Chairman

Jay R. Eliason, President

-C22-

02/07/1989 15:33 FROM CTI TO 13122414569 P.01

FEB 07 1989

COMMODITY TRADERS, INC.

7171 Mercy Road - Suite 255 • Omaha, Nebraska 68106-2610
Telephone: 402-391-3474

February 7, 1989

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, IL 60604

Dear Mr. Chairman:

It has been brought to my attention that the directors of the Chicago Board of Trade could possibly stop the practice of dual trading.

I've been an active broker in the midwest for the past twenty years trading commodity futures for county elevators, farmers and livestock producers.

I would like to express my opinion against the proposed change. Any change that would reduce liquidity or keep a broker from filling spread orders with the utmost speed and accuracy I would strongly oppose.

I agree that the temptation to cheat is always present where high amounts of money are involved. I do not feel 99% of the brokers dealing in an industry with well over a century of trading activity should be penalized by a few dishonest people.

Yours truly,

William J. Dostal

WJD:ae

FEB 07

Refco, Inc.

889 Ridge Lake Boulevard
Suite 301
Memphis, Tennessee 38119

Telephone
901 766-4650

REFCO®

February 3, 1989

VIA TELECOPIER 312-341-3392

Mr. Karsten Mahlmann
Chairman
Chicago Board of Trade
LaSalle at Jackson
Chicago, IL 60604

Dear Mr. Mahlmann:

Re: Dual Trading

As a member of the Chicago Board of Trade and a user of the futures market, I encourage you to not act hastily in eliminating dual trading. I certainly believe there are some advantages in giving liquidity and movement within the market and I think we should do a detailed study and not be provoked into making a decision in the short run that might, in the long run, hurt the Board of Trade and the futures industry.

Sincerely,

Willard R. Sparks
Vice President

WRS:ptm
cc: Tone Grant
Thomas H. Dittmer

-C24-

FEB 07

QUINCY Soybean COMPANY
Producers of Quality Soybean Products

(217) 224-1800 • TELEX: 40-4421 • 1900 GARDNER EXPRESSWAY • P.O. BOX 329 • QUINCY, ILLINOIS • 62306-0329

February 2, 1989

Mr. Karsten Mahlmann, Chairman of the Board
Mr. Thomas R. Donovan, President
Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Il. 60604

Dear Messrs. Mahlmann and Donovan:

Quincy Soybean Co. is a soybean processor and incidentally a member firm of the Chicago Board of Trade. We employ no representatives as traders on the floor of the exchange, but we execute trades through several commission houses for hedging purposes in our day to day activities.

We are very concerned about the action taken at the Chicago Mercantile Exchange to disallow " dual trading." We would hope that the Chicago Board of Trade leadership would give much more consideration and study before taking similar actions at the Board of Trade. Now is not the time for panicky reaction to public opinion and as yet unsubstantiated charges by the press and others.

There is no doubt that abuses do occur, but the system at the Chicago Board of Trade functions effectively. As a member firm who uses the exchange facilities extensively, we strongly admonish the exchange leadership to avoid premature actions that would result in more long term harm in trading effectiveness and liquidity.

Best regards,

QUINCY SOYBEAN CO.

Richard Galloway

J. Richard Galloway
Vice President of Marketing

JRG:rt

FEB 07 1989

Soybean Update

"A Soybean Association publication for members"

FEBRUARY 6, 1989

VOLUME 13 NUMBER -

Market Struggles With Soy Supply Outlook

Near-term demand fundamentals may look good, but ample long-term supply prospects are limiting price movement, some analysts say. A sizable South American crop looming in the background, and talk of increased U.S. plantings this spring are holding futures in check.

However, other sources contend South American production isn't "in the bag" yet, and parts of the U.S. growing areas are critically short of subsoil moisture. They say markets will trade sensitive to world weather until stocks are rebuilt to comfortable levels.

Beans On Base Announcement Expected

Sign-up for the special provision to plant soybeans on permitted program base ended last Friday, and a USDA official tells *Update* a final announcement on the amount to be allowed could come as soon as mid-February.

If USDA reduces the amount producers signed up for, it will likely be by a straight factor. For example, if USDA says farmers may only plant 50 pct of their own sign-up percentage, a producer asking to plant 25 pct of his base to beans would only be allowed to plant 12.5 pct.

Soviet Purchase Maximum Bumped Up Again

Aggressive Soviet Union grain buys and a potential crop shortfall there encouraged USDA to bump up again the annual maximum purchases allowed from the U.S.

The original 12 mln tonne agreement was raised to 16 mln in December and has now been hiked to 20 mln. Although soy purchases count toward the 9 mln tonne annual minimum, they don't count toward the maximum.

Soviet Union Reenters U.S. Meal Market

Another 150,000 tonnes of U.S. soymeal were purchased by the Soviet Union recently, and some think more buys could be on the way. However, given the track record of purchases and cancellations, sources are hesitant to second-guess Soviet needs. In addition, meal shipments to the USSR have been sluggish.

Chicago Market Probe Stirs Industry Talk

The probe into futures trading in Chicago is bringing both criticism and praise from industry contacts.

Last week, the Federal Bureau of Investigations revealed agents had been posing as traders in the soybean pit, among others, to uncover potential wrongdoings.

The inquiry centers on "bucket trading"—transactions which don't give investors (such as farmers) the best possible price for their trades. Instead, a broker may fill the order at a couple of cents above or below what the investor wants and pocket the rest.

Although it's too early to discuss any specific findings or possible impact on soybean futures trading, ASA Staff Vice-President Dennis Sharpe says the FBI's investigation perpetuates fear and distrust among market users.

"It's unfortunate. Farmers benefit greatly from the CBoT's price discovery function. The futures market provides a way to lay off price risk," Sharpe says.

A study into 1984-85 soybean futures price movement conducted by ASA surfaced some unethical practices, but Sharpe says on balance the findings were positive.

Soybean farmer Ken Dalenberg, a member of the Board's Ag Advisory Council, says, "We need to clean up the problem and maintain integrity. Producers can't expect to get 100 pct of every market order they place. But if the system is abused, there's discipline in place."

Floor sources note trading volume has dipped since the investigation was made public, but it can't be solely blamed for the drop in volume. A lack of fresh fundamental news has also subdued trading interest.

Supplies Tighten On Strong Bean Exports

Small pockets of tight soybean supplies are growing into larger areas of pinched availability. Slack producer sales and increased export interest last week combined to firm Gulf soybean values. Export inspections hit a 1988-89 marketing year high last Monday, and another dynamic showing is expected again this week.

"Farmers are still not willing sellers at these price levels. Most producers want to see $8.00/bu. cash beans again," says one elevator manager in the Midwest.

The higher export inspections figure comes on the heels of the recent soybean price drop to November lows.

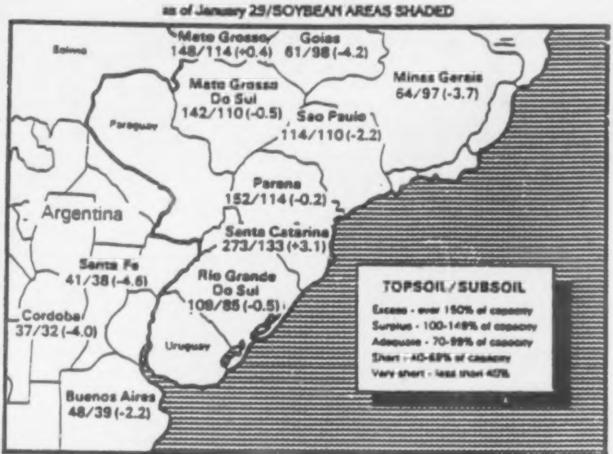
In The Week Ahead . . .

- Reaction to Thursday's USDA Supply/Demand Report
- Possible announcement of beans on base percentage
- Ongoing talk of potential South American crop size
- Likely increased feeding rates due to cold snap
- Growing attention to U.S. spring weather outlook

SOYBEAN UPDATE [illegible]

SOUTH AMERICAN SOIL MOISTURE

as of January 29/SOYBEAN AREAS SHADED


Bolivia
Mato Grosso
148/114 (+0.4)
Goias
61/98 (-4.2)
Minas Gerais
64/97 (-3.7)
Mato Grosso
Do Sul
142/110 (-0.5)
Paraguay
Sao Paulo
114/110 (-2.2)
Parana
152/114 (-0.2)
Argentina
Santa Catarina
273/133 (+3.1)
Santa Fe
41/38 (-4.6)
Rio Grande
Do Sul
109/85 (-0.5)
Cordoba
37/32 (-4.0)
Uruguay
Buenos Aires
48/39 (-2.2)
TOPSOIL/SUBSOIL
Excess - over 150% of capacity
Surplus - 100-149% of capacity
Adequate - 70-99% of capacity
Short - 40-69% of capacity
Very short - less than 40%

(Departure in inches from normal)

Courtesy of Global Weather Services

South American Supplies May Temper Stocks: Use Impact

As South American soybean production takes a growing share of the world market, analysts say the U.S. ending stocks to use ratio may begin to lose its influence on price direction.

"We have to look at world stocks to use ratio now. South America has capacity to offset what the U.S. does not have," says Shearson's Mickey Luth.

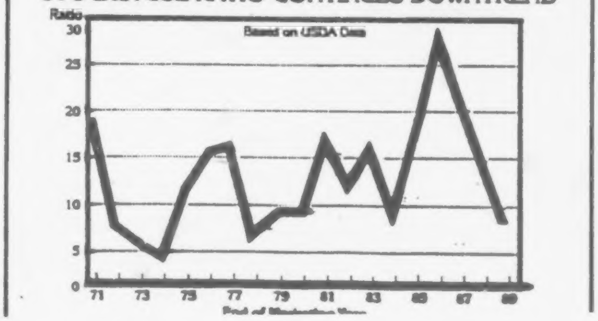
Because of the impact the South American crop has on the whole picture, some sources say it is more accurate to concentrate on quarterly stocks.

"History says Jan. 1 stocks were one of the nine tightest in the last 35 years. If you look ahead, however, and see South American production, then Mar. 1 isn't as tight," one adds.

Other analysts watching the ratio say historically, this year's figure is near the low end of the range. Using USDA's January ending stocks estimate of 140 mln bushels and total usage of 1701 mln bushels, the ratio is 8.2.

"In the past, a ratio as low as 8.2 has called for prices to move higher to ration use and encourage production. A large South American crop just tempers the optimism to raise prices," says another industry contact.

STOCKS: USE RATIO CONTINUES DOWNTREND



Daily Rains Blanket Braz:

Rainfall has become a daily e much of Brazil's growing regions which has been favorable for cea

"We've seen eight inches of ra average in southeast Brazil in Jar says Freese-Notis' Harvey Freese.

Analysts and meteorologists re: the ideal conditions may have enc aged some producers to plant mo: beans than originally intended.

But as Brazil gets wetter, Argen continues to just hold its own. Mete gists say light showers have been enough to sustain plants but not rebuild soil moisture levels.

"Rain in most of Argentina over last two weeks has been anywhere from 30-70 pct of normal," Freese

Brazil Delays Oil Exports

Brazil may temporarily delay sc exports, as a price freeze in effect produce domestic oil shortages.

A Brazilian government contact *Update* soyoil export registrations w probably be suspended until March April to assure internal supplies.

"The popular brand names are no longer on supermarket shelves. Peo panic and buy up the oil," he says.

This consumer "panic buying" is what is causing soyoil supplies to appear limited, Brazilian analysts say.

In fact, many note the country's sta tics show enough soyoil is available the critical month of February.

Sources say typically consumers f an oil shortfall this time of the year, c the recent price freeze on soyoil has heightened supply concerns.

Frigid Temps Alter Outlook

The recent mercury plunge in the U.S. may freeze up marketing activity while meal feeding rates could get hc

The drop from last week's balmy te peratures has lent strength to the so complex, on ideas processors may want more beans and soymeal users may want more supplies if cold persis

"The cold weather is catching interest in soymeal, but it may also stall cou try movement of grain," says UT America/G.H. Miller's Jerry Gidel.

Meteorologists say extreme cold is possible, following one of the warmes January in the Midwest on record.

However, 30-day and 90-day ou

Futures In Trading Range

Nearby beans appear to be in a trading range with a possible downward bias, technicians say.

Stotler's Pat Locper estimates Mar could go to $7.40/bu. or lower. "There's a 50-50 chance we could take out Nov/Jan lows and still go lower," he notes.

On the upside, Tim Case of Timothy S. Case Commodities says Mar beans may go up to $7.80.

He also anticipates a pull-down in Mar soybean prices first. He expects the downward move will take place by the last week of February or first week of March.

"There's not a lot of room on the downside but it will be a good buying opportunity," he says.

Oil Stocks Sour EEP Talk

A glut of soyoil supplies is renewing ideas new offers of export bonus may be made.

Analysts say large supplies, as confirmed in the recent Census Bureau report, are an underlying factor to price depression.

"Aggressiveness is needed. The problem is we don't know who to give export bonus to," says Prudential-Bache's Dick Loewy.

Several EEP recipients from the last marketing year still hold credits, including India. But a good oilseed crop in that country may mean fewer vegoil imports.

Cutting oil stocks through a slower crush pace is unlikely.

S&D To Show Few Changes

Few revisions to the supply/demand balance sheets are expected in Thursday's monthly report.

Many analysts are penciling in the same changes they anticipated USDA to make in the January report which never materialized.

Given the sluggish export pace and oncoming South American crop, analysts are dropping their export guess below USDA's 565 mln bushels by as much as 40 mln.

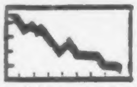
To offset lower exports, many also expect the crush estimate to be raised by a similar amount.

An equal switch-off between the two would maintain an ending

NEWS & VIEWS

Soybean Associat[illegible]

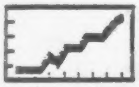
Threats. . .



Vegoil Imports On The Rise

Foreign vegetable oil supplies continue to flow into the U.S., ASA Staff V-P of Economics & Corporate Relations Dennis Sharpe says. "The cut throat competition in the world export markets drove prices far below domestic U.S. prices. Now, oil is flowing into the U.S. in significant quantities." USDA estimates soybean oil imports have escalated from zero in 1985/1986 to a projected 200 mln pounds for the 1988/89 marketing year.

Opportunities. . .



Poultry Growth May Boost Soymeal Use

If broiler production steadily increases at its current rate, Senior Vice President of Pilgrim's Pride John Haid, expects U.S. poultry production to increase by as much as 72 pct by the year 2000.

This growth translates into potential increased use of soybean meal in poultry feed rations. Haid says it takes 424,000 soybean acres to meet Pilgrim's soymeal needs. All U.S. broiler and commercial egg producers consume 11.14 mln soybean acres, which is 20 pct of the U.S. bean crop. A 72 pct increase could mean another 150 mln bushels of soybeans.

Meal Market Potential In USSR

ASA's first feeding trials in the Soviet Union were such a success that the Soviets would like to see additional trials conducted. But checkoff investments are needed to ensure the expansion goes to the U.S. ASA estimates that the U.S. could claim 300 mln bushels of the potential USSR soymeal demand.

A Soviet newspaper printed trial results in an article which concluded soybean meal is truly a worthy universal protein supplying ingredient for all types of livestock and poultry.

Listening Sessions Successful

ASA's out listening to farmers. So far, ASA's Policies for the 1990s Task Force has conducted listening sessions in Minnesota, Mississippi, Texas, Tennessee/Kentucky, Louisiana, North Carolina/South Carolina and Georgia. The Task Force has 16 more sessions scheduled in February. The Task Force also surveyed more than 3,000 farmers for policy ideas.

"The response from the country has been overwhelming," says Ed Hester, 1990s Task Force member from Benoit, Mississippi. "It has definitely been an educational experience. . .it has really opened my eyes to the concerns and ideas of other farmers in the different states."

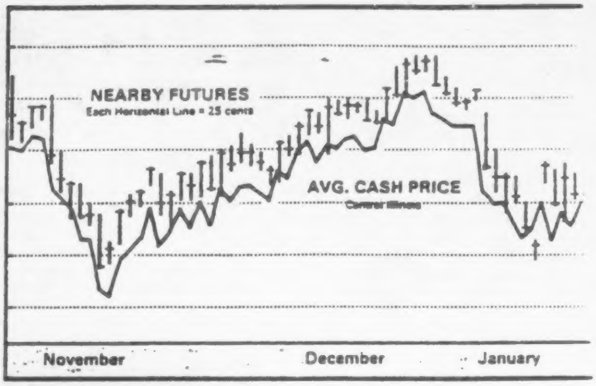
During the listening sessions, randomly-selected farmers, both members and non-members, are asked to discuss four topic areas: environmental and ag chemical issues, export and trade issues, Third World and Latin American debt and domestic farm policy.

The Task Force wants to hear from you! It's developed a policy handbook and workbook for farmers to express ideas and concerns. If you haven't received a copy of the booklets, contact your state Soybean Association or call ASA at 800/USA-SOYA (in MO, 314/432-1600). Ask for extension 117.

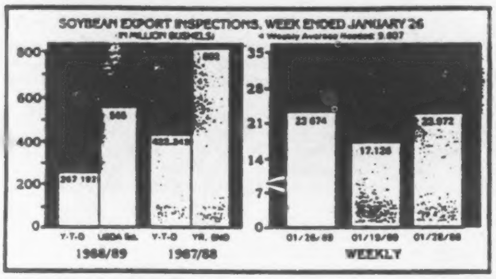
SOY STATS

SOY OUTLOOK

South American weather and demand will remain key market factors in the soy complex this week. The trade will become more and more responsive to crop estimates from both Brazil and Argentina. Strong demand for soybeans and soymeal should support nearby futures, especially if producer selling is needed to meet demand. Meanwhile, direction of deferred soybean futures will hinge on soybean planting ideas in the U.S. Thursday's USDA report may also dictate price movement by week's end. Cold temperatures should lend support to meal; but if the crush pace picks up to meet meal demand, soyoil prices will probably drag.



SOYBEAN EXPORT INSPECTIONS, WEEK ENDED JANUARY 26



CASH SOYBEAN PRICES

Location	Spot Price Jan. 31	Change	Location	Spot Price Jan. 31
Decatur, Ill	$7 79¾	(+ 27½)	Decatur, Ala.	$7 72¼
Davenport, Iowa	7 56¾	(+ 24½)	Montgomery, Ala	7 73
Des Moines, Iowa	7 55¼	(+ 24½)	Central Ark.	7 73¾
Sioux City, Iowa	7 50¾	(+ 25½)	Gainesville, Ga.	7 87¾
Indianapolis, Ind.	7 70¾	(+ 25½)	Southern Ga.	7 47¾
Louisville, Ky.	7 69¾	(+ 24½)	New Orleans, La.	7 98¾
Minneapolis, Minn	7 49¾	(+ 24½)	Northeast La.	7 71¾
Kansas City, Mo.	7 69¾	(+ 26½)	Salisbury, Md.	7 83
St. Louis, Mo	7 79¾	(+ 25½)	Greenville, Miss.	7 73¾
Omaha, Neb.	7 50¾	(+ 25½)	Elizabeth City, N.C.	7 65¾
Cincinnati, Ohio	7 81¼	(+ 25½)	Charleston, S.C.	7 82¾
Toledo, Ohio	7 84¾	(+ 25½)	Memphis, Tenn.	7 82¾

( ) Change from Jan. 25 N/A - Not Available Unch - Unchanged
Jan. 31 CBT prices: Mar 7.72¾
Source: Commodity News Services

NSPA Weekly Crush Statistics

Week Ending
01-25-89 .... 18.993 88/89 Total 322.931
01-18-89 .... 19.383 87/88 Total 251.138
01-27-88 .. 20.724 USDA Estimate .. 1,040.000
(In Million Bushels)

Technical Statistics

Contract	Weekly Trend	Close 1/31	Resistance Maj.	Resistance Min.	Support Min.	Support Maj.
Mar Beans	Up	7.72¾	8.20	8.00	7.40	7.20
Mar Meal	Up	249.60	279.00	262.00	240.00	238.00
Mar Oil	Up	21.93	24.00	23.00	21.00	20.00

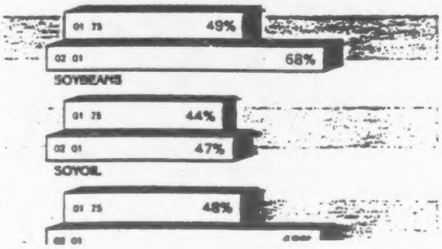
Comparative Stats

(Rotterdam in dlrs per tonne CIF)

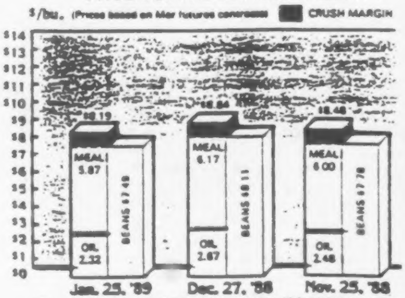
	Current	Week Ea
U.S. Soymeal	283.00	278.0
Braz. Pellets	303.00	299.0
Arg. Pellets	291.00	288.0
Jan Delivery		

BULLISH CONSENSUS

Bullish Consensus is a measure of overbought and oversold conditions. Over 70% indicates overbought, while 30% shows oversold.



PRODUCT VALUE PER SOYBEAN $



The value of oil and meal tells the processor which products to [illegible]

FEB 06 '89 10:20 FCC DM. IOWA -C29- P.3

FEB 06 1989

FARMERS COMMODITIES CORPORATION
HEADQUARTERS: (MAILING ADDRESS) P.O. BOX 4887, DES MOINES, IOWA 50306-4887
515-223-3788 • IOWA WATS 800-422-3087 • NATIONAL WATS 800-247-4104 • TELEX 439 025

February 6, 1989

Mr. Tom Donovan
President and Chief Executive Officer
Chicago Board of Trade
LaSalle at Jackson
Chicago, Illinois 60604

Dear Tom:

I would like to commence this letter by commending you and your people on the position you have taken so far in this ordeal you are experiencing. I know there is tremendous pressure from the floor brokers to fight back and to react to the challenge that has been presented to you by outside sources. Therefore, I believe that before you have all the facts and before you know what can be done constructively, you are doing the proper things.

My main concern, as president and C.E.O. of a clearing member, is somewhat different. I personally believe that dual trading, or brokers who trade for themselves and for companies such as ours, has far more value than detriment. Therefore, rather than prohibiting this from happening, I would like to recommend that it be monitored and controlled through a series of audit trails much as the clearing members are monitored and controlled by the exchanges and other regulatory agencies. The integrity of the system could be maintained by having the brokers submit daily position reports, auditing brokers monthly, and notifying members as to those brokers who would like to perform broker/trader functions. There should also be some control procedures in place to prohibit these brokers from exercising discretion about trades. The market needs the added liquidity that the broker/trader represents. Our firm selects the brokers who execute our trades and if the broker doesn't perform to our standards, we change brokers.

The monitoring system could be financed from a sur charge on the brokers business on a per round basis so that there not be a new and additional cost to the exchanges.

I hope that a constructive compromise can be achieved to continue provide adequate liquidity in the market and quality of brokers handling member business that the exchange will continue to have value to us as it has in the past.

I regret very much that a very small minority in the pit is presenting such a problem to all of us but recognize that this is not something new - that it is the history of any system.

Thank you for your kind attention. I wish you success in a quick solution to these problems.

Sincerely,

Harold L. Richard

Harold L. Richard
President

HLR/pa

FEB 06 '89 11:47 COMMODITY CAPITAL P.01

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board of Trade
Chicago
Illinois 60604

Commodity Ca
233 Via Villena
Encinitas
California 92024

February 6th 1989

Dear Mr. Mahlmann,

I write to you with some comments on the proposal to ban "dual trading" on the CBOT.

I believe that such a move is unwarranted unless it can be shown that the existence of this system has led to abuses which cannot be controlled by so other means. Outlawing dual trading would have the following negative effects.

1) Liquidity would be jeopardised. This would particularly apply to back month liquidity. Brokers would no longer be able to compete with locals in the execution of deferred spreads (they would be prohobited from taking risk such a in "legging a spread"). The resultant less favorable executions would eventually "kill" trading of deferred spreads and thus reduce open interest.

2) Trasactions costs would increase. There would be a tendency for brokers to want to become locals. I believe that this would apply to the most compete brokers in particular. This would either lead to less efficient execution by the second-tier brokers or a higher brokerage rate charged by the better brokers.

I have been trading cash grains or grain futures as a full time occupation since 1976. I have worked for two grain exporters (Continental Grain and Louis Dreyfus) and I am currently a CTA. I believe that dual trading enhances liquidity and promotes competitive transactions costs. Unless the CBOT is convinced that there are abuses stemming from dual trading that cannot be ameliorated in any other way, a bannning of this activity should be avoided.

Yours Sincerely,

Mark R. Hawkins

-C31-

Bridgeport Securities Group

312/66

FEB [illegible]

February 6, 1989

Dear Mr. Mahlmann:

I just want to drop you a line to let you know I feel that prohibition of dual trading will hurt liquidity, the public and the exchange.

Sincerely,

Girondi

Patrick Girondi

401 S. LaSalle
Suite 203
Chicago, IL 60605

-C32-

MAR 23 198

Deerfield-Farms

9041 Rt. 224 • Deerfield, Ohio 44411 • (216) 584-4715

March 17, 1989

Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann:

I have recently been made aware of some discussion within the CBOT organization pertaining to the ability of the floor brokers to trade Dualty, for personal as well as customer accounts simultaneously.

Speaking from the perspective of industry (grain) and brokerage (formerly AP, current CTA), I don't think it would be beneficial to anyone to eliminate the ability of brokers to Dual trade. Liquidity is one thing that has made the CBOT efficient and a great market place for all concerns. Eliminating Dual trading may severely affect the kind of liquidity that has enabled the CBOT to serve commercial and public concerns with the quality that it is known for. This is not, in my opinion, an abuse of the marketplace.

I want to also compliment you for the good job in regulating the activities on the floor thus far and I'm sure that your decisions will insure an efficient, fair market place for years to come.

Sincerely,

Jeff Koenig
Grain Merchandiser, CTA

tr

cc White Commercial Corp.

Appendix D

ALTERNATIVE MARKET MECHANISMS FOR LIQUIDITY

Broker trading greatly enhances the liquidity of futures markets. It minimizes the bid/ask spread and lowers transaction costs, helping to ensure that U.S. futures markets continue to dominate the world's futures industry. Broker trading restrictions would reduce this liquidity creating greater costs for all traders and handicapping the ability of U.S. markets to compete internationally. As discussed earlier, such restrictions pose clearly identifiable costs on the market for benefits that are only conjectural, at best.

The CFTC letter of March 8, 1989 suggested that other trading mechanisms may compensate for the liquidity lost with broker trading restrictions. Specifically, four trading mechanisms were suggested in the letter as substitutes for broker trading -- market makers, sunshine trading and large and small order trade execution procedures. In fact, these other mechanisms are not substitutes for broker trading for reasons discussed below.

Marketmakers

A marketmaking system creates a special category of floor participant with particular responsibility for ensuring an active market is maintained for a commodity. This responsibility usually requires that a two-way market be offered within a maximum price spread up to a maximum order size. In return for this responsibility, a set of structured incentives is put into place. These incentives are designed to compensate the marketmakers for the provision of liquidity services.

In the presence of broker trading, a marketmaker has an additional source of income; i.e., brokerage, to supplement the income generated from marketmaking. In the absence of broker trading, the income generated from marketmaking would have to be higher to induce a party to provide liquidity services. Given equivalent demand for marketmaking, with and without broker trading, increased income can only come from an enhanced incentive program. These financial incentives to provide additional liquidity services will raise the overall transaction costs in the market via new fees or franchised monopolies. Ironically, customers (commercial firms) will be paying a premium to obtain a service - liquidity - that was available under the broker trading regime at a lower cost. The additional incentives required to induce additional liquidity services under a segregated regime constitute a dead weight cost to society with no offsetting benefit. Furthermore, it is doubtful that in a rapidly moving market a single marketmaker could substitute for the liquidity provided by competitive multiple broker traders.

Since it is commercial firms who put value on liquidity services it should be their province to determine the most effective market structure for delivering those services. Under a broker trading regime commercial firms have the discretion to execute their orders through a broker who only fills orders or a broker who also trades for his own account. Obviously a firm will seek the individual who provides the best "fills" and a broker trader who consistently provides inferior service will lose business in the competitive environment. Thus, in the broker trading regime a level of market discipline exists that can only be created in a marketmaker system without broker trading by isolating market roles and forcing a higher cost.

Sunshine Trading

Sunshine trading is a trading practice which involves prearranged trading and thus is currently illegal at the Exchanges. Proponents of sunshine trading claim that its introduction would work to reduce the "liquidity costs" faced by commercials in their execution of orders on the floor. Scalpers would be compensated for the services they provide to the market, primarily the fact that they stand ready to either add or deplete their inventories in order to take the opposite side of orders entering the pit. The size of the bid/ask spread is a function of the compensation required to assume this role. Formally stated, scalpers set their bid/ask spread equal to their expected revenue from liquidity seeking traders minus their expected loss from informed traders.

Informed traders have proprietary information exclusive to them and take positions according to the insight they gain from it. These "informed traders" impose losses on scalpers who stand ready to take the other side of an "informed" trader's order but are not privy to his store of information. Thus, to protect themselves against these sorts of losses to "informed" traders, scalpers raise their bid/ask spread to compensate for losses on trades.

Sunshine trading would purportedly reduce the risk to scalpers of taking the opposite side of certain trades and hence reduce the premium on the bid/ask spread due to this precautionary behavior. The preannouncement of a trade is alleged to reduce uncertainty by indicating a trade is not based on exclusive information but on the individual's financial requirements or general market conditions. Therefore, the expected loss from lack of information should be zero. With the reduction of information risk, a scalper should be able to quote a smaller bid/ask spread without changing return expectations.

Sunshine trading is also designed to force the reduction of the bid/ask spread by increasing competition and volume. Knowledge of the coming trade is supposed to increase competition by attracting additional scalpers to the floor and commercials willing to place market orders on the opposite side of the market at the same time. Volume is to increase as scalpers establish inventories to offset against the pre-announced trade. The increased volume and competition are designed to enhance liquidity on the floor, narrowing the bid/ask spread.

In the short run sunshine trading would be expected to marginally increase commercial volume, but to lead to a reduction in speculative activity, especially scalping. The overall net effect on exchange activity would be a reduction in exchange volume because the increased commercial volume would not offset the reduction in speculative activity.

Over the long run the migration of scalpers from futures markets is inevitable in the face of these lower average returns. Scalpers, like any other economic agents, would seek out a higher return for their capital. In the face of lower returns, scalpers would leave the market until the point at which the constriction in liquidity services once again raises the return scalpers obtain back to a competitive level. Transactions costs would rise for all traders thus reducing the informational efficiency of futures markets.

As advocates for sunshine trading would probably admit, this trading mechanism is not designed to create a general increase in market liquidity. Instead, sunshine trading is designed to address only one type of trade, the supposedly informationless large trade that could arise in the context of program trading. The merits of sunshine trading aside, sunshine trading is not a substitute for broker trading and would not compensate for liquidity lost under broker trading restrictions.

Large Order Execution Systems

Large order execution systems, commonly known as "block trading" developed due to a perception of insufficient liquidity in security markets. Like sunshine trading, block trading involves prearrangement and is illegal at the Exchanges. The securities markets developed an alternative system for trading blocks rather than use specialist execution on the floor. Block trades are pre-arranged off the floor between a buyer and seller through a broker. All terms including price are set when the transaction is taken to the floor for its execution and de facto announcement. It is argued that pre-arrangement is necessary due to the lack of liquidity on the floor.

It should be noted that price effects from block trades have been identified. These effects occur after the trade rather than with the trade, therefore, reducing pricing efficiency in these markets. Temporary effects on price from seller-initiated transactions and permanent price effects from buyer-initiated transactions have been attributed to the demand for liquidity and to the emergence of new information.

It has been asserted that an economic need exists for block trading of futures contracts even with broker trading. The desire for such trading presumably originates from securities market participants.1/ Certainly a trade that is too large for execution in the current bid/ask spread could be readily envisioned. The

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1/ Apparently, traditional market users such as grain companies, have found the current trading method adequate to meet their needs. This may reflect increased sophistication by traditional users or differences in cash market experiences.

difficulty with such trading is readily apparent and is the basis for its illegality. With pre-arranged trades, information is not incorporated into the central marketplace in futures market via bids and offers on the floor in the execution of such trades. Instead, the price response is delayed with prices adjusting only after the trade is executed. The net effect of such trading is a less efficient pricing mechanism, the loss of price transparency and a reduction in the effectiveness of futures prices for price-basing and risk-shifting (since futures prices contain less information).

Block trading would enable the execution of large trades in a single fill. Some firms may find this desirable despite the fact that the single price may not be the best price for the order. Such a system would displace some of the liquidity lost via dual trading restrictions; however, its cost would be a loss of pricing efficiency for all market users and it would not address general liquidity needs for small and medium size orders.

Small Order Execution System

Most automated small order execution systems exist only in the context of a larger, non-automated auction market. These small order execution systems provide an auxiliary market function - the execution of small orders - and do not have the capacity to perform exchange functions on a stand alone basis. Small order execution systems use a market price - obtained in the larger, auction market - as a reference price with which to execute orders against the accounts of participating market makers. Small order systems are essentially passive systems - there is no capacity within the system to alter the price in response to change in the flow of (small) orders. The working assumption in the incorporation of any small order system is that the "economic weight" of such small orders will never be substantial enough to significantly affect the current market price, and that in the aggregate most small orders to buy are offset by small orders to sell. In essence, exchange officials have determined that the transactions cost of executing these small orders in the central auction marketplace will outweigh any minuscule effect on price these orders would have. Ultimately, all small order systems, whether automated or not, must be passive derivative systems that obtain the execution price for small orders from the main auction market.

The introduction of a small order execution system into a pre-existing auction market would not effectively change the amount of speculative capital required to maintain the same degree of liquidity in the pit. The level of capital necessary to support marketmaking activity would remain the same whether small orders are matched in the pit, or assigned passively through an automated execution system. What is crucial, however, is that a trader who agrees to match order on an execution system must have access to the trading pit to hedge the exposure of his accumulated positions. If traders were prohibited from simultaneously executing orders in the pit, there would be a significant increase in exposure and a consequent reduction in participation in the small order systems. The results would be a dramatic loss in liquidity for small orders, obviating the very reason for the introduction of a small order execution system in the first place. Small orders would then return to the floor with the incumbent dead weight loss in transactions costs from floor congestion imposed on all transactions.

Thus, these trading mechanisms are designed to address specific trade execution needs that have arisen in the context of the current broker trading system. These four mechanisms have developed in the securities markets. The liquidity in these markets, whether cash government securities or equities, comes primarily from upstairs trading between broker dealers; i.e., broker traders.

Moreover, it is important to recognize that two of these mechanisms -- sunshine trading and block trading -- are currently illegal in futures markets owing to the prearrangement of trading which they require and the longstanding objection in futures markets against prearrangement as a source of abuses and reduced competition. If prearrangement of trades, and hence sunshine and block trading, were legalized in the interest of promoting liquidity, the upstairs broker traders would be the principal users of these mechanisms as they are in securities markets. Sunshine and block trading would be done to execute proprietary trades, customer trades or a combination of both. However, as this prearranged broker trading activity (sunshine trading and block trading) would be carried out upstairs rather than openly on the floor of the Exchanges, a more difficult surveillance challenge would be created. Instead of open broker trading in a pit, there would be "hidden" upstairs broker trading. The securities industry has not developed any surveillance structure for upstairs broker dealers (broker traders) comparable to the surveillance structure already in place for open broker trader dealings in futures exchanges.

In conclusion, none of these systems are designed to substitute for the liquidity of broker trading. In fact they are part of a securities market structure where broker trading is not only the key to liquidity but also hidden in an upstairs market that is far less regulated.

Appendix 3: 1987 and 1988 Disciplinary Action Summary

1988
DISCIPLINARY ACTION SUMMARY

DEPARTMENT	# OF CASES TP / TOTAL	# OF INDIVIDUALS/ FIRMS CITED TP / TOTAL	FINES / PENALTIES TP / TOTAL
AUDITS	263 / 263	7 / 14	9,000 / 15,500
FINANCIAL SURVEILLANCE	0 / 139	0 / 17	0 / 15,500
INVESTIGATIONS	1,166 / 1,176	25 / 35	1,291,000 / 1,309,500 FINES 180 / 206 DAYS SUSP. 16 1/2 / 16 1/2 YEARS SUSP. 4 / 4 REPRIMANDS 1 / 1 PERMANENT BAR 2 / 2 C & D
MARKET SURVEILLANCE	7 / 27	7 / 18	146,000 / 209,500
R-R-R	28 / 28	14 / 14	4,250 / 4,250
TOTAL	1,464 / 1,633	53 / 98	1,450,250 / 1,554,250

TRADE PRACTICE VIOLATIONS

DEPARTMENT	INTERNAL/EXTERNAL/TOTAL	FINES - PENALTIES INTERNAL/EXTERNAL/TOTAL
AUDITS	7 / 0 / 7	9,000 / 0 / 9,000
FINANCIAL SURVEILLANCE	0 / 0 / 0	0 / 0 / 0
INVESTIGATIONS	15 / 10 / 25	1,231,500 / 57,000 / 1,291,000 FINES 144 / 36 / 180 DAYS SUSP. 16 1/2 / 0 / 16 1/2 YEARS SUSP. 4 / 0 / 4 REPRIMANDS 1 / 0 / 1 PERMANENT BAR 0 / 2 / 2 C & D
MARKET SURVEILLANCE	7 / 0 / 7	146,000 / 0 / 146,000
R-R-R-	14 / 0 / 14	4,250 / 0 / 4,250
TOTAL	43 / 10 / 53	1,390,750 / 57,000 / 1,450,250

1988
TOTAL CASES

DEPARTMENT	INTERNAL	EXTERNAL	# OF CASES
AUDITS	263	0	263
FINANCIAL SURVEILLANCE	139	0	139
INVESTIGATIONS	949	227	1,176
MARKET SURVEILLANCE	27	0	27
R-R-R	28	0	28
TOTAL	1,406	227	1,633

TP CASES

DEPARTMENT	INTERNAL	EXTERNAL	TOTAL
AUDITS	263	0	263
FINANCIAL SURVEILLANCE	0	0	0
INVESTIGATIONS	949	217	1,166
MARKET SURVEILLANCE	7	0	7
R-R-R	28	0	28
TOTAL	1,247	217	1,464

1987

DISCIPLINARY ACTION SUMMARY

DEPARTMENT	# OF CASES TP / TOTAL	# OF INDIVIDUALS/ FIRMS CITED TP / TOTAL	FINES / PENALTIES TP / TOTAL
AUDITS	274 / 274	7 / 12	48,500 / 62,500
FINANCIAL SURVEILLANCE	0 / 196	0 / 8	0 / 23,500
INVESTIGATIONS	995 / 1,002	27 / 34	72,000 / 77,550 176 / 219 DAYS SUSP. 13 / 13 REPRIMANDS 1 / 1 PERMANENT BAR 1 / 1 C & D
MARKET SURVEILLANCE	10 / 53	10 / 24	5,000 / 54,000
	1,279 / 1,525	44 / 78	125,500 / 217,550

TRADE PRACTICE VIOLATIONS

DEPARTMENT	INTERNAL/EXTERNAL/TOTAL	FINES - PENALTIES INTERNAL/EXTERNAL/TOTAL
AUDITS	7 / 0 / 7	48,500 / 0 / 48,500
FINANCIAL SURVEILLANCE	0 / 0 / 0	0 / 0 / 0
INVESTIGATIONS	3 / 24 / 27	47,000 / 25,000 / 72,000 FINES 166 / 10 / 176 DAYS SUSP. 13 / 0 / 13 REPRIMANDS 1 / 0 / 1 PERMANENT BAR 0 / 1 / 1 C & D
MARKET SURVEILLANCE	10 / 0 / 10	5,000 / 0 / 5,000
TOTALS	20 / 24 / 44	100,500 / 25,000 / 125,500

1987
TOTAL CASES

DEPARTMENT	INTERNAL	EXTERNAL	# OF CASES
AUDITS	274	0	274
FINANCIAL SURVEILLANCE	196	0	196
INVESTIGATIONS	971	31	1,002
MARKET SURVEILLANCE	10	0	10
TOTAL	1,451	31	1,482

TP CASES

DEPARTMENT	INTERNAL	EXTERNAL	TOTAL
AUDITS	274	0	274
FINANCIAL SURVEILLANCE	0	0	0
INVESTIGATIONS	971	24	995
MARKET SURVEILLANCE	10	0	10
TOTAL	1,255	24	1,279

Robert E. Fink
First Vice-Chairman

Commodity Exchange, Inc. (COMEX)
Board of Governors

Mr. Fink is an independent trader on the COMEX floor, trading for his own account as well as those of individual and institutional clients.

A member of the Exchange since 1982, Mr. Fink serves as First Vice Chairman of the Board of Governors. He is also a member of the Board's Executive Committee. Mr. Fink is familiar with the Exchange's disciplinary process, having served as a member of the Committee on Business Conduct for five years. He is currently the chairman of that committee.

His working knowledge of COMEX also extends to the area of operations and systems. He has been directly involved in the design and implementation of the Exchange's state-of-the-art automated trade submission system, as a member of the Operations Committee, and is serving as its Chairman for the 1989-90 year.

Mr. Fink's expertise has been developed over 18 years in the futures industry. He is a veteran faculty member of the New York Institute of Finance and has also been a contributor to the Commodity Research Bureau (CRB) yearbook. In 1987, Mr. Fink co-authored Futures Trading: Concepts and Strategies, an introductory textbook for the industry. He is also a member of the Cotton Exchange. Mr. Fink is a graduate of Columbia University.

COMMODITY EXCHANGE, INC.

Disciplinary Sanctions, 1984-1988 For Violations Arising From Trading Activity.

Year	Number	Fines	Suspensions (Days)
1984	39	$359,500	0
1985	26	506,000	210*
1986	30	428,800	332
1987	32	701,000	1,009
1988	35	622,500	593

*In addition, one member agreed to withdraw from membership.

Prepared by Commodity Exchange, Inc.

COMEX COMMODITY EXCHANGE, INC. FOUR WORLD TRADE CENTER, NEW YORK, N.Y. 10048 • (212) 938-2915

Alan J. Brody
President and
Chief Executive Officer

April 28, 1989

Ms. Andrea M. Corcoran
Director
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Ms. Corcoran:

This is written in response to your letter of March 8, 1989 in which you requested certain information on the subjects of the Exchange's audit trail program and dual trading in connection with a review of these issues by the Division of Trading and Markets (the "Division").

Commodity Exchange, Inc. ("Comex" or the "Exchange") is proud of its compliance record and efforts in the audit trail context and welcomes this opportunity to respond to the Division's inquiries.

As reflected in the information provided below as well as in the Division's August 29, 1988 Audit Trail Rule Enforcement Review of the Exchange, Comex has successfully implemented integrated and efficient audit trail systems, in compliance with the requirements of Rule 1.35(g), and currently conducts an effective trade practice surveillance and compliance program designed to deter, detect and enforce penalties for a variety of trading abuses. See appendices to Statement of Dr. Wendy Lee Gramm Before the Senate Committee on Agriculture, Nutrition, and Forestry, March 9, 1989, captioned "Exchange Compliance Staffs" and "Appendix A - Monetary Sanctions Imposed by Exchanges for Trade Practice Violations."*

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* Please note that the tabulation set forth in Appendix A understates the monetary sanctions issued by Comex in 1987 by $370,800. With respect to the document captioned

(cont'd. on next pg.)

COMEX

Ms. Andrea M. Corcoran
Page Two
April 28, 1989

In addition, as summarized below, the Exchange is continuously engaged in the review and development of its trade entry, surveillance and compliance systems to enhance the effectiveness of the Exchange's existing audit trail and ensure the integrity of the Exchange's self-regulatory function.

We have set forth below the conclusions of our preliminary review of the verifiability of timing data and the reliability of source documents at the Exchange. We have also provided the data you specifically requested relating to dual trading on the Exchange, together with the preliminary conclusions of our initial review of dual trading and consideration of certain other proposals identified by you as potential alternative means of enhancing liquidity on U.S. futures exchanges.

The information summarized in this letter was gathered under the aegis of a Special Advisory Panel (the "Panel") appointed by the Board of Governors of the Exchange (the "Board") for the purpose of reviewing current Exchange practices, market practices and new technologies and making recommendations to the Board. The Panel is comprised of two non-Exchange members (one, a public Governor of the Board

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(cont'd. from pg. 1)
"Exchange Compliance Staffs," the budgetary figures attributed to Comex's compliance program do not reflect the items listed by the Commission in its description of the figures. It is therefore possible that the budgets of other exchanges reflect allocations for various types of expenses which have been reported to the Commission without consistency. Moreover, the staffing levels shown and the reported decrease in the Comex compliance budget are inaccurate - in fact, the Compliance Department budget was not decreased at all between 1986 and 1988. Based upon these observations, to enable the performance of any type of meaningful comparison of these data, we would urge the Commission to specify guidelines for the collection of Exchange budgetary information and to verify the data, once collected, with each exchange.

and the other, an academician specializing in the field of futures markets), two Exchange members (one the chairman of a large futures commission merchant and the other a major investor and money manager in the futures markets); and four Exchange members on the Board (one representing commission house members, one representing floor broker members, one representing floor trader members and one representing trade group members). In connection with the Panel's review, extensive interviews were conducted by Panel staff (on a non-disclosure basis) with members of the Panel, members of the Board (including representatives of the Board's floor group, commission house group and trade group) as well as Exchange staff involved in compliance and related, automated systems development. In all, Panel staff interviewed 23 individuals, including major market participants and users. In addition, Panel staff conducted a very preliminary analysis of the dual trading data requested by you.

Nonetheless, it simply has not been possible to complete a comprehensive review and analysis of the various subjects touched upon in your letter within the brief time allotted, although we have conducted an extensive review of many of these subjects and have made every effort to be as complete as time would allow in preparing our response. As a result, certain of the views expressed in this letter are necessarily preliminary and are likely to evolve as the Panel proceeds in the course of its mandate to review these and other related subjects.

I. AUDIT TRAIL

A. Verifiability of Timing Data.

1. Current Exchange Procedures and Systems.

The Exchange has developed an integrated, on-line trade entry system which captures trade data throughout the trading day and forms the database for the Exchange's various surveillance systems designed to monitor compliance with the Exchange's audit trail requirements and detect a variety of trading abuses. Comex requires all floor brokers and traders to manually record to the nearest minute the time of execution of each transaction on the floor of the Exchange (including both sides of each trade). See Comex

Rules 4.80(a)(2)(F) and 4.81(f). That trade data is submitted by floor brokers/traders to their respective clearing members. All trade data required to be submitted to the Exchange by clearing members is entered directly by the clearing members into the Exchange's automated trade entry system from trading cards and order tickets submitted to them for clearance. In order to enter a trade into the system, all trade data describing the trade, including the time of execution (to the nearest minute), must be included.

This data is maintained in the Exchange's automated clearing system and, once matched, is used to produce a daily recapitulation, by broker/trader, of all transactions executed on that day (known as the Daily Brokerage Recap or "DBR"). Thus, the Exchange has an on-line record of each trade in its automated trade register. To the best of our knowledge, no other U.S. futures exchange captures complete trading data, as promptly or frequently as Comex.

The Exchange also maintains a Price Change Register ("PCR") detailing by contract all price changes (and corresponding time to the nearest second) reported by the Exchange's pit reporters.

The data contained in the DBR and PCR are compiled and analyzed to generate compliance reports to verify the accuracy of manually recorded execution times. These include (i) the weekly Broker-to-Broker Execution Time Comparison One Day Summary Report and the monthly Broker-to-Broker Execution Time Comparison Periodic Summary Report (the "Broker-to-Broker (one day/monthly) comparison reports"), and (ii) the weekly Broker Execution Time Versus Price Change Register Detail Report and the monthly Broker Execution Time Versus Price Change Register Periodic Summary Report (the "Broker-to-PCR (one day/monthly) comparison reports").

At the end of each week the Exchange prepares a Broker-to-Broker (one day) comparison report and a Broker-to-PCR (one day) comparison report, using trade data from the DBR (for all brokers/traders) and price/time data from the PCR for a randomly selected trade date during that week. At the end of each month, the Exchange prepares a Broker-to-Broker (monthly) comparison report and a Broker-to-PCR (monthly) comparison report, using the aggregate data from all the one day comparison reports reviewed during that month.

Very generally, the Broker-to-Broker (one day) comparison report identifies all instances during the reference trading day in which the times of execution recorded by the brokers/traders on each side of a trade are more than one minute apart. The Broker-to-Broker (monthly) comparison reports are based on the aggregate data collected for each trading day examined during the reference month.

The Broker-to-PCR (one day) comparison report identifies all instances during a trading day in which the time of execution reported by a broker/trader varies by more than one minute from the nearest time (if any) recorded on the PCR as the time period in which trades were executed at the corresponding price. The Broker-to-PCR (monthly) comparison report is based on the aggregate data collected for each trading day examined during the reference month.

In combination, these reports provide a powerful and effective surveillance tool for the Exchange, enabling the Exchange both to identify discrepancies in the manual recordation of timing data and, in the context of a particular investigation, to verify the accuracy of manually recorded execution times. As discussed more fully below, this permits the Exchange to perform market surveillance without undue reliance on the accuracy of manually recorded execution times. We believe that these systems are fully responsive to the Division's suggestion that each exchange should have a prompt means of detecting recordkeeping violations.

As noted by the Division in the 1988 Comex Audit Trail Rule Enforcement Review, in an average of 87% of all trades executed on Comex, the time of execution recorded on the applicable trading card/order ticket is accurate to within one minute of the corresponding entry on the Price Change Register. This compares favorably with the experiences of other exchanges which, one year later, continue to experience significantly lower levels of accuracy or continue to have inadequate procedures for verification of compliance with such standards.

Unlike the audit trail programs implemented by other exchanges, Comex's audit trail system does not rely in the first instance on a computerized trade reconstruction program in order to "reconstruct" and assign an execution time to a particular trade. (Although, as described above, Comex does have computer programs which assist in the verification of manually recorded timing data.) Consequently, the Exchange's systems do not depend upon measuring and making generalized assumptions about the handling of customer orders and average length of time necessary to execute a customer order in a particular market (which may or may not be accurate in a particular case). Similarly, Comex does not rely on the timing data supplied by only one side of a trade to impute the time of execution.

In addition, the Exchange has submitted to the Division for its approval proposed rule changes that would implement summary fines for violation of the one minute time recordation requirement. The Exchange intends to monitor and review the impact of these rules on compliance with a view to determining their effectiveness. The Exchange is hopeful that these measures will improve the Exchange's accuracy rate (based on the Broker-to-PCR comparison report) within the next six months.

In addition to the foregoing, the Exchange, through the Panel and various committees of the Board, is currently engaged in the review of a variety of new systems, technologies and methodologies that would assist in the verification of trade execution data. These are discussed further below.

2. Integrity of Source Documents.

In your letter you recommend that the Exchange "have adequate procedures to prevent the alteration or fabrication of source documents" and suggest certain procedures to accomplish this result, including "more frequent collection of trading cards, member use of presequenced and pre-identified (as to trader) trading cards, and member use [of] or accountability for all trading cards and all lines on trading cards in sequence."

The Exchange currently employs a number of procedures that minimize the opportunity to fabricate or alter source documents and increase the opportunity for detection of such activities. These preventive measures include the presence of floor officials and the half-hourly collection of trading cards. Under Comex Rule 4.83, each floor broker/trader is required to submit his/her trading card/order tickets to his/her designated clearing member within 15 minutes following the expiration of the 30 minute trading bracket in which the related trade is executed. (As a practical matter, most order tickets are submitted within minutes of execution.) Each clearing member is required to enter that trade data into the Exchange's on-line trade entry system. Thus, trading cards are collected half-hourly on the Exchange.

The Exchange has also recently adopted rules which provide the Exchange with the flexibility to reduce the permitted intervals for trade data submission and the Exchange is currently encouraging all members to submit trading cards/order tickets for trade entry at the earliest time that trading permits.

In addition, duplicates of each trading card and order ticket are retained by each clearing member and, in some instances, trade data is transcribed onto brokerage submission forms for ease of data entry. Each of these documents is available to the Compliance Department for comparison purposes in an investigation.

Although the frequency of trading card collection can continue to be improved, any such improvement must be gradual and must be implemented in a manner which is not disruptive to trading. The Exchange feels strongly that it should avoid the imposition of cumbersome procedures which may have a disruptive impact on trading (and, consequently, the efficiency of its markets). These may result in higher costs to the trading public (in lost market efficiency) than the incremental cost savings that might result from reducing the opportunity to fabricate documents in order to conceal trading abuses. This consideration is relevant to any new procedure that is intended to alter the practices of brokers/traders.

The Exchange's inability to entirely eliminate the opportunity to alter or fabricate documents is mitigated by the Exchange's use of other systems which are designed to detect the abuses such alteration or fabrication are intended to conceal. The Exchange's Broker-to-Broker and Broker-to-PCR comparison reports are examplas of such systems.

In addition, the Compliance Department has recently begun to operate various proprietary analytic programs against the data contained in the Exchange's DBR which, very generally, are designed to elicit trading patterns and relationships which may be evidence of trading abuses. The results of these analyses are contained in "exception reports" which are periodically reviewed by the Compliance Department. Although the Exchange has only recently begun to use these analytics, they constitute a powerful surveillance tool. Moreover, as the Exchange gains experience in utilizing these systems, they will continue to gain in sophistication.

Comex is thus an industry leader in the implementation of audit trail procedures and related surveillance systems which provide the means to assure to a reasonable degree the integrity of its markets. As the compliance records of the Exchange demonstrate, the Exchange has a history of prosecuting cases relating to the alteration of records. Many of the changes which other exchanges are currently examining in order to improve their current procedures and systems are designed to accomplish essentially what Comex already has in place.

The Exchange has nonetheless continually and is currently investigating a number of additional measures and/or technologies to preserve the integrity and verifiability of source records. Because the Exchange has not completed its review of these, however, we are only able to provide the Division with our preliminary views as to their advantages or disadvantages.

A. More Frequent Collection of Cards. As noted above, the Exchange has already implemented relatively frequent collection of trading cards. We are currently reviewing the feasibility and efficiency of instituting a more frequent collection schedule.

B. Mandatory Sequencing. The Exchange believes that mandatory sequencing of trading cards and trade entry lines together with a prohibition against card skipping and line skipping may have the potential to enhance the reliability of the Exchange's audit trail. However, we believe that it is necessary to study the implications of such requirements in order to assess the potential impact of these requirements on brokers/traders and clearing members, and accordingly, the Exchange is initiating such a study. (Order tickets on the Exchange are already pre-sequenced.)

C. Hand-held Computer Technology. The Exchange has been investigating hand-held computer technology for a significant length of time. Although the various component technologies are known to exist, there is no currently available prototype which integrates these technologies and is ready for implementation in the near future. Such technology possesses many desirable attributes (including the potential for immediate, or near immediate, on-line capture of trade data and creation of unalterable, automatically timestamped execution records). At the present time, however, a feasible, cost-effective model does not exist.

D. Enhanced Surveillance. The Exchange currently has an on-floor surveillance program. The Exchange believes that surveillance measures are desirable, particularly for their deterrent effect. The Exchange also believes that electronic visual surveillance, given enough cameras, could also perform a useful deterrent function and if it were to incorporate internal time-clock and sound recordation technology, would also be useful in reconstructing the timing and sequence of events in the context of a matter already identified for review. The Exchange has mandated an internal study of Exchange floor surveillance which will consider extending our existing floor surveillance into the trading rings as well as the use of surveillance technology.

II. DUAL TRADING

We have enclosed with this letter the data you requested regarding dual trading.

While we question whether this data would provide an adequate empirical basis on which to reach definitive conclusions regarding the impact of dual trading on liquidity, we have nonetheless begun an analysis of this data in response to your request. However, the Exchange is only in the preliminary stages of its efforts to sort and review the data collected on this subject, and therefore, we are not currently in a position to provide a comprehensive statistical analysis. Of course, we will apprise the Division of our conclusions as soon as we have completed our analysis.

Based upon the Panel staff's interviews, we believe that dual trading provides significant benefits in addition to market liquidity.* These include the following:

1. The presence of dual traders in a trading ring supplies flexibility which enables floor traders to respond to changing market conditions, e.g., providing immediate additional brokerage capacity in a fast market, thus enhancing the efficiency of the market. This flexibility would be lost if dual trading were to be abolished.

2. There is a consensus that dual traders provide better brokerage services because of their greater trading expertise and sensitivity to market forces.

3. There is a consensus that the abolition of dual trading will increase the cost of brokerage services.

4. Some former dual traders will be unable to support themselves either solely from brokerage or solely from trading, causing a shake-out in the rings which might reduce the total number of brokers/traders in the ring and further potentially reduce liquidity.

It was also noteworthy that, in the course of the interviews conducted by Panel staff of users of the markets, all without exception stated that they used (and the substantial majority indicated that they sought out) dual traders for the execution of their orders, notwithstanding the potential conflict of interest dual trading presents. While not every interviewee was prepared to endorse dual trading unreservedly, not one interviewee articulated the view that the disadvantages of dual trading merited its abolition.

Trading ahead of a customer order, or "frontrunning" -- the primary abuse of dual trading -- has been prohibited for many years and is the most readily detectable abuse by an effective audit trail coupled with a diligent compliance effort. Moreover, seven years ago, in an effort to eliminate what was perceived to be the most common method of frontrunning, Comex adopted a rule, unlike any other exchange's, which prohibits floor members from trading opposite customer orders, either directly or indirectly. This prohibition applies not only to the floor broker executing the customer order but to any other member of the Exchange affiliated with the executing floor broker, whether through formal partnership or employment arrangements or through more informal or temporary means. See Comex Rule 4.24. The effect of this prohibition has been that a floor broker attempting to take the other side of a customer order, in conjunction with his trading ahead of that order, must engage in other trading abuses, such as prearranged trading with another member, which make that form of frontrunning more easily detected.

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* Five of the twenty-three individuals interviewed by panel staff were dual traders.

To uncover these types of activity, the Compliance Department utilizes the DBRs, in conjunction with the newly developed exception reports generated by the Exchange's automated surveillance program. These surveillance tools enable the Compliance Department to identify trading patterns which may evidence trading abuses. For example, the exception reports utilized by the Compliance Department are intended to look for instances in which a trader earns profits on trades in the same contract and on the same side of the market as his/her customer.

The abolition of dual trading would eliminate only one means of trading abuse, direct frontrunning, but would not affect other trading abuses which disadvantage customers. Each of the other (also currently prohibited) methods of effecting similar results, such as withholding of customer orders and the disclosure of customer orders in exchange for profit-sharing -- each an indirect form of frontrunning -- would remain unaffected by the prohibition of dual trading.

The abolition of dual trading is thus unlikely to have a meaningful impact on many types of trading abuses. At the same time, the abolition of dual trading has the potential of rendering the markets more illiquid, less efficient and more expensive (although perhaps in certain markets more than others) without providing any material corresponding benefit.

The Exchange believes that the systems, rules, practices and procedures currently used by it to detect, investigate and sanction trading abuses are effective tools and establish an industry benchmark. The materials referred to in the third paragraph of this letter demonstrate the Exchange's commitment to maintaining the integrity of its markets. The Exchange is continuing to review and improve its audit trail and surveillance programs, and we expect such improvements to enhance our ability to detect and deter trading abuses. In addition, in connection with the Division's focus on dual trading, we note that the Exchange is expanding its education program for floor clerks -- a program which stresses the importance of timely and accurate submission of trade data. The Exchange is also revising its education program for floor brokers to include an ethics course for all new Exchange members and is considering expanding the course to include all Exchange members.

You have also requested that we consider whether certain other measures might provide an adequate substitute for dual trading, such as sunshine trading, large order execution procedures, small order execution procedures, or use of marketmakers. These alternatives have each, at one time or another, been widely discussed and debated by the futures industry. It is not possible at this time to provide an analysis of the Exchange's views on these alternatives. Certain of these measures are currently under review by the Exchange. Each has certain desirable advantages and each its disadvantages. However, we note that although each of these alternatives has the potential to supplement dual trading as a potential source of liquidity under certain market conditions, none provides liquidity in the same manner and under the same circumstances as dual trading -- and none provides the advantages of dual trading unrelated to liquidity mentioned above. Thus, the Exchange believes that none is a substitute for dual trading.

III. CONCLUSIONS

As noted above, the Exchange has, over the years undertaken a number of initiatives to improve its audit trail program and to enhance trade practice surveillance. These include systems which generate automated reports, such as the Broker-to-Broker comparison reports, the Broker-to-PCR comparison reports and the automated surveillance system's exception reports. These initiatives also include rulemaking, such as rules requiring the manual recordation of timing data, rules requiring the collection of trading cards within 15 minutes of the applicable 30 minute trading bracket and rules (currently under review by the Division) imposing summary fines for time recordation infractions.

In addition, the Exchange is currently undertaking a number of new initiatives. These include the expansion of the Exchange's training programs and establishment of an ethics course for new Members (and possible extension to all Members). The Exchange also has constituted the Panel in order to assist the Board in connection with its review of the Exchange's current procedures and the various alternative initiatives available to the Exchange.

Thus, Comex has developed and implemented an effective audit trail program and has demonstrated its commitment to maintaining fair and honest markets. Comex is currently reviewing, as are many exchanges, and will continue to review, alternatives such as those discussed above, recognizing the necessity to preserve the integrity of its self-regulatory function. This process should be allowed to continue in order to permit the Exchange to develop effective solutions which promote the integrity of its markets without burdening those markets or rendering them less efficient.

Very truly yours,

Alan J. Brody

Alan J. Brody
President and
Chief Executive Officer

(Attachments follow:)

Appendix A

Monetary Sanctions Imposed by Exchanges for Trade Practice Violations

1986 - 1988 */

	1986	1987	1988
CBT	$180,500	190,100	287,000
CME	$285,400	2,098,925 */	717,250
COMEX	$441,450	330,200	592,500
NYMEX	$ 95,000	0	32,500
CSC	$147,275	63,925	47,500
NYCE	$ 23,550	9,225	1,400
NYFE	$ 23,125	6,750	72,022
KCBT	$ 65,000	13,500	1,500
MACE	$ 400	0	0

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*/ The remaining exchanges imposed no sanctions during this period.

*/ This amount includes 14 sanctions of $50,000 or more.

Exchange Compliance Staffs

Figures generally include staff who have direct duties in the Compliance Department, e.g., trade practice, audit trail, financial audits, market surveillance, and legal and computer staff.

Chicago Board of Trade	1980	1982	1984	1986	1988
Compliance Budget	$1,016,000	1,337,000	2,004,000	2,657,000	3,553,000
Compliance Staff	44	48	70	78	83

Chicago Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Budget	$2,036,000	3,008,000	3,785,000	5,925,000	7,830,000
Compliance Staff	32	37	40	60	89

Coffee, Sugar and Cocoa Exchange	1980	1982	1984	1986	1988
Compliance Budget	$411,535	661,385	616,500	676,000	852,000
Compliance Staff	19	19	17	17	23

Commodity Exchange, Inc.	1980	1982	1984	1986	1988
Compliance Budget	$622,000	890,000	1,155,000	1,527,135	1,015,000
Compliance Staff	24	34	39	29 10/	33

Kansas City Board of Trade	1980	1982	1984	1986	1988
Compliance Budget	$90,000	145,000	175,000	368,000	252,600
Compliance Staff	4	6	7	7	5

Minneapolis Grain Exchange	1980	1982	1984	1986	1988
Compliance Budget	$76,800	105,000	118,230	167,350	312,000
Compliance Staff	2	2	2.5	[illegible]	8

New York Cotton Exchange	1980	1982	1984	1986	1988
Compliance Budget	$444,087	550,155	504,394	869,000	1,400,000
Compliance Staff	10	11	10	17	15

New York Futures Exchange	1980	1982	1984	1986	1988
Compliance Budget	$3,395,000 11/	2,156,000 12/	400.000 13/	1,100,000	1,050,000
Compliance Staff	22	16	6	7	11

New York Mercantile Exchange	1980	1982	1984	1986	1988
Compliance Budget	N/A	710,690	812,500	819,359	2,345,000
Compliance Staff	11	15	20	18	33

SOURCE: Commodity Futures Trading Commission

COMEX

MEMBERS OF COMMODITY EXCHANGE, INC. SPECIAL ADVISORY PANEL

Dr. Andrew F. Brimmer, Chairman of the Special Advisory Panel, is president of Brimmer & Company, Inc., an economic and financial consulting firm which monitors and analyzes economic activity, developments affecting financial institutions, and interest rates in money and capital markets. Dr. Brimmer serves as a public governor at COMEX. Previously, he was on the Board of Governors of the Federal Reserve System from 1966 through 1974. Dr. Brimmer was also a visiting professor at Harvard University's Graduate School of Business Administration from 1974 through 1976.

John J. Conheeney serves as Chairman of the Board of Merrill Lynch Commodities Inc., a wholly-owned subsidiary of Merrill Lynch Futures Inc., and was a Board member of the Chicago Board of Trade, Chicago Mercantile Exchange, and COMEX. Mr. Conheeney also served as Vice Chairman of the National Futures Association at the time of its formation in 1982. Mr. Conheeney currently is a member of the Executive Committee of the Futures Industry Association and served as its Chairman from 1982 to 1984.

Mark H. Denberg is an independent floor trader and served on COMEX's Board of Governors from 1985 through 1988. Mr. Denberg first became a COMEX member in 1963, leaving in 1966 to join the New York Cocoa Exchange and returning in 1969. A former Chairman of the Exchange's Business Conduct Committee and Audit Trail Committees, he is currently a member of the Floor Facilities and Floor Committees.

Franklin R. Edwards is on the faculty of the Columbia Business School and has served as the Director of the University's Center for the Study of Futures Markets since 1980. Dr. Edwards has been a Columbia University faculty member since 1966 and served as Vice Dean of the Business School from 1979 to 1981. He holds a Ph.D. degree from Harvard University and a J.D. degree from the New York University Law School. Dr. Edwards' major areas of research and expertise are the regulation of financial markets and institutions, banking, securities markets, and futures and options markets.

Martin Greenberg, president, Sterling Commodities, has served on COMEX's Board of Governors since 1987 as a commission house representative. Mr. Greenberg has been an Exchange member since 1976. Mr. Greenberg is currently Chairman of COMEX's Margin and Supervisory Committees and is a former Vice Chairman of the Exchange's Floor Committee.

COMEX

Robert Harmon, Jr. has been a COMEX member since 1979. He began his career in the industry with Harmon, Lichtenstein & Co. in 1971, becoming a partner in 1979. Mr Harmon became an independent floor trader in June 1986. Mr. Harmon has held a seat on COMEX's Board of Governors since March 1988 and currently serves as Chairman of the Exchange's Arbitration and Floor Facilities Committees as well as the Member Relations Subcommitttee. Mr. Harmon is also Vice Chairman of the Business Conduct, Marketing and Exchange Relations and Arbitration Committees. A member of the New York Bar since 1979, Mr. Harmon earned a J.D. degree from the University of Miami School of Law in 1978.

Paul Tudor Jones serves as chairman, director and sole stockholder of Tudor Investment Corporation, a major investment and money management company in the futures industry. He is currently a member of COMEX, the New York Cotton Exchange, the Coffee, Sugar and Cocoa Exchange, the New York Futures Exchange, the Chicago Board of Trade and the IMM division of the Chicago Mercantile Exchange. Mr. Jones currently serves as Treasurer of the New York Cotton Exchange and is acting Chairman of the Financial Instruments Exchange. Mr. Jones is also a member of the board of the Futures Industry Association.

David M. Pryde is senior vice president of Morgan Guaranty Trust Co., where he is responsible for directing all global trading and marketing of precious metals. Formerly with Philipps Brothers Hong Kong Ltd., as Vice President, Bullion Trading, New York, Mr. Pryde has extensive metals market experience in London, New York and the Far East. Mr. Pryde currently serves on COMEX's Supervisory and Precious Metals Committees and has been an Exchange member since 1985. Mr Pryde was elected to the COMEX Board of Governors, representing trade firms, on March 14, 1989.

QUESTIONS SUBMITTED BY SENATOR LEAHY, HEARING ON COMMODITY FUTURES MARKETS, MAY 17, 1989

DUAL TRADING

I understand that you agree with me that dual trading must exist side-by-side with an effective audit trail system, and that your exchange is or soon will be capable of maintaining a 90 percent audit trail accuracy rate. To guarantee the public that this standard is adhered to, is there any reason that Congress should not ban dual trading in any adequately liquid pit where, in fact, the exchange audit trail system fails to meet the 90 percent standard? Otherwise, we could not guarantee that abuses are being effectively policed.

I assume, for purposes of this question, that the judgment of which trading pits are adequately liquid would be made by the CFTC.

PROPOSALS—CBT, NYMEX, COMEX

Please comment on whether you think the following proposals, which appeared in the April 19 report of the Chicago Mercantile Exchange special committee, should become industry standards:

—That floor compliance staff be authorized to inspect all trading floor documents, including customer orders and trading cards, immediately on the spot;

—That the so-called "fast market" designation, under which a broker's responsibility to fill his customer's orders is lessened during periods of high price volatility, be eliminated. In order words, brokers would be held to the same standard of care in executing customer orders no matter how fast the market is moving.

QUESTIONS SUBMITTED BY SENATOR LEAHY FOR THE CHICAGO BOARD OF TRADE

PENALTY DATA

In the Supplemental Submission with your testimony, the CBT presented data showing that it had imposed trade practice-related monetary sanctions of $125,500 in 1987 and $1,450,000 in 1988. These figures were quite different from data previously supplied by the CFTC and the GAO.

In order to understand the basis of these statistics, please provide:

—A description of the accounting system used to calculate these statistics, and how you understand it to differ from the methodologies used by the CFTC and the GAO;

—A detailed breakdown of cases included in the 1987 and 1988 data, including the rule violation alleged and the fine imposed in each. We are particularly interested in whether the $1.125 million fine imposed by the CBT against Thompson Sanders is included in the 1988 figure; and

—A listing, based on your accounting system, of the amount of trade practice-related fines imposed by the CBT in 1984, 1985, and 1986.

QUESTIONS SUBMITTED BY SENATOR LEAHY FOR THE CHICAGO MERCANTILE EXCHANGE

CME DUAL TRADING PROPOSAL

The CME's special committee, in its proposal to bar dual trading in "mature, liquid" pits, left open three exceptions. And some critics have asked whether these exceptions might be big enough to swallow the rule.

One scenario which, I understand, was raised at a recent legal conference in Baltimore, was that large brokerage firms with 100's or even 1,000's of customers might simply begin asking *all* customers to sign preprinted waiver forms allowing the firm to handle the account through dual traders. These waiver forms would be included in the firm's standard package of account-opening papers.

Question. How would you envision that the proposed dual trading ban—particularly the exception for dual traders who receive written permission from their customers—would apply in this case? Would your proposal allow such large-scale waivers through preprinted forms?

QUESTIONS SUBMITTED BY SENATOR CONRAD, HEARING ON COMMODITY FUTURES MARKETS, MAY 17, 1989

Questions for the witnesses.

1. What are the possibilities for expanding electronic futures trading? Would such an expansion make it easier to create an audit trail on transactions in order to discourage fraud?

2. How effective do you think the Commodities Futures Trading Commission has been in regulating the futures markets? Senator Kerrey brought up the matter of unpaid CFTC fines—what could your exchanges do to help the CFTC collect these fines?

3. How would you suggest that the CFTC oversee or regulate your self-regulation efforts? Are your newly installed computer procedures to allow transaction monitoring and auditing readily available to the CFTC for their own monitoring efforts? How compatible and comparable are the transaction monitoring systems in the different markets you represent?

4. The industry seems to be split on the question of banning so-called dual trading where brokers trade for themselves as well as for customers. I would like each of you to state your position on this issue and describe what you think would be the practical consequences of banning dual trading? If you favor no restrictions on dual trading, how do you propose that your internal monitoring systems and those of the CFTC prevent possible abuse in these types of transactions?

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

Mr. Melamed

1. First, let me commend the Chicago Mercantile Exchange for acting swiftly in reviewing current trading practices and making broad recommendations for change. In reading through your report, I must admit being slightly confused. If public perception is what is driving many of the changes we are hearing today, why would you recommend a ban on dual trading but not on broker associations? What are the benefits and risks associated with broker associations? What limitations are there on trades among members of broker associations?

2. It seems the Merc has taken somewhat of a lonely position with regard to dual trading. Do you envision your recommendation to ban dual trading in months that have reached Mature Liquidity to be permanent? In other words, if it is being done solely to react to public perception? Two years from now when the CFTC has been reauthorized and life returns to normal on the exchanges, do you envision the ban being lifted?

Karsten Mahlmann

1. I am interested in your thoughts on the Merc's recommendation to ban dual trading on mature, highly liquid contracts. How would this type of ban impact the CBOT?

2. I know that your exchange has commissioned a study on the effects of dual trading. If public perception is as important as everyone seems to believe, do you think another study will be acceptable?

CHICAGO MERCANTILE EXCHANGE

COMPOSITION OF THE CHICAGO MERCANTILE EXCHANGE BOARD OF GOVERNORS

The Chicago Mercantile Exchange (CME) Board of Governors is comprised of elected and appointed officials which fall into three broad categories: Elected Governors, Public Governors, and Industry Governors At Large.

ELECTED GOVERNORS

There are 24 Elected Governors of the Board representing the 3 divisions of the Exchange in the following breakdown: Members of the CME Division elect 12 CME governors; members of the International Monetary Market (IMM) Division elect 8 IMM governors; and members of the Index and Options Market (IOM) Division elect 4 IOM governors.

Each Governor is elected for a 2-year term. Every year, one-half of the governors from each division are up for reelection. The 6 CME, 4 IMM and 2 IOM governors are elected each year from a slate of 12, 8 and 4 nominees, respectively.

Exchange rules do not establish categories from which a member must be elected. However, every attempt is made by the Nominating Committee, whose members are elected by the membership, to ensure that the slated candidates represent a broad cross-section of Exchange membership.

For example, with respect to the 24 elected members currently serving on the Board of Governors, several of whom are floor brokers or traders, 16 represent retail or institutional broker/dealers, trade firms, or other clearing member firms. The Board elects its own officers annually, except in the case of Special Counsel who is appointed for a 2-year term.

APPOINTED GOVERNORS

PUBLIC GOVERNORS

There are three Public Governors appointed by the Chairman, upon approval by the Board, for a 2-year term. Public governors may not be members of the Exchange. Public governor candidates include those individuals who are respected leaders in their field and who will represent the public interest. It is the CME's desire to have the input of these public representatives when making policy decisions.

Historically, one of the Public Governors has been a past president of the National Cattlemen's Association (NCA). This slot is currently filled by Donald Butler, President, Coronado Cattle Company, and was previously filled by Jo Ann Smith, both of whom were recent past presidents of the NCA.

The other two Public Governors are filled from a wide spectrum of the public sector including former public officials and representatives from academia. Presently, Susan M. Phillips, past Chairman of the CFTC and currently Vice President of the University of Iowa, and Thomas F. Eagleton, former U.S. Senator from Missouri, and now with the law firm of Thompson & Mitchell, serve on our Board. Other recent Public Governors have included Dean Donald Jacobs, J.L. Kellogg Graduate School of Management, Northwestern University, and John White, Past Chairman, Democratic National Committee.

INDUSTRY GOVERNORS AT LARGE

There are three Industry Governors At Large who are appointed by the Chairman, upon approval by the Board, for a 2-year term. Industry governors must be representatives of CME clearing member firms. The Exchange looks for respected persons who are in senior management positions and who represent a cross-section of our industry. Historically, Industry Governors have represented a strong balance of brokerage firms from throughout the CME membership including wirehouses, trade firms and institutional broker/dealers.

Currently, Robert B. Feduniak, Managing Director, Morgan Stanley & Co., Inc.; Louis I. Margolis, Managing Director, Salomon Brothers; and Katsuya Takanashi, Chairman, Nomura Securities International, Inc. serve on our Board in this capacity. In the recent past, some of the member brokerage firms represented on the CME Board included Kidder Peabody & Co.; Thompson McKinnon Securities, Inc.; Goldman Sachs Corp., E.F. Hutton & Co., Inc.; Drexel Burnham Lambert; Citibank, N.A.; Merrill Lynch Futures, Inc.

CHICAGO MERCANTILE EXCHANGE RESPONSES TO QUESTIONS POSED BY SENATE AGRICULTURE COMMITTEE MEMBERS AT MAY 17, 1989 HEARING ON TRADING PRACTICES IN FUTURES MARKETS

QUESTIONS SUBMITTED BY SENATOR LEAHY

1. I understand that you agree with me that dual trading must exist side-by-side with an effective audit trail system, and that your exchange is or soon will be capable of maintaining a 90 percent audit trail accuracy rate. To guarantee the public that this standard is adhered to, is there any reason that Congress should not ban dual trading in any adequately liquid pit where, in fact, the exchange audit trail system fails to meet the 90 percent standard? Otherwise, we could not guarantee that abuses are being effectively policed.

I assume, for purposes of this question, that the judgment of which trading pits are adequately liquid would be made by the CFTC.

CME Response: The CME has not taken any final position on the dual trading issue. Its Special Committee to Review Trading Practices made extensive recommendations which were presented to this Committee and which are currently being considered by a committee comprised of knowledgeable Exchange members.

Without taking a final position on the general issue, the CME and its Special Committee do agree that it is inappropriate for Congress or the CFTC to make determinations respecting whether a contract is "adequately liquid." The Special Committee and the Exchange both believe that the CME is the only entity qualified to assume the initial burden of making a liquidity and maturity determination for its contracts in connection with regulating dual trading. If an exchange fails to properly exercise this responsibility, the CFTC has adequate authority to force corrective action.

2. The CME's Special Committee, in its proposal to bar dual trading in "mature, liquid" pits, left open three exceptions. And some critics have asked whether these exceptions might be big enough to swallow the rule.

One scenario which, I understand, was raised at a recent legal conference in Baltimore, was that large brokerage firms with 100's or even 1,000's of customers might simply begin asking *all* customers to sign preprinted waiver forms allowing the firm to handle the account through dual traders. These waiver forms would be included in the firm' s standard package of account-opening papers.

Question. How would you envision that the proposed dual trading ban—particularly the exception for dual traders who receive written permission from their customers—would apply in this case? Would your proposal allow such large-scale waivers through preprinted forms?

CME Response: The Special Committee to Review Trading Practices considered the possibility of mass waivers and, thus, adopted an exemption that applies to *specific* brokers. The language of the Committee report was that an exemption be granted "to floor brokers who have received specific permission annually, in writing, from the ultimate customer, which specifically identifies the broker."

QUESTIONS SUBMITTED BY SENATOR CONRAD

1. What are the possibilities for expanding electronic futures trading? Would such an expansion make it easier to create an audit trail on transactions in order to discourage fraud?

CME Response: The CME is convinced that electronic trading will not succeed without the liquidity provided by open outcry pit trading. Trades executed through GLOBEX, our electronic system, will be electronically timed to a period of no more than one second.

2. How effective do you think the Commodity Futures Trading Commission has been in regulating the futures markets? Senator Kerrey brought up the matter of unpaid CFTC fines—what could your exchanges do to help the CFTC collect these fines?

CME Response: We believe the CFTC has distinguished itself and favorably compares with all federal and state agencies performing similar regulatory and enforcement functions. The fines involved in Senator Kerrey's examples were not directed at exchange members, but at illegal off-exchange and otherwise unregistered individuals. The exchanges have no jurisdiction over such individuals; however, if the fine were against one of our members and the matter had been finally adjudicated with no remaining appeal rights, we would ensure that the fine were paid before allowing the member to continue to do business on the CME.

3. How would you suggest that the CFTC oversee or regulate your self-regulation efforts? Are your newly installed computer procedures to allow transaction monitoring and auditing readily available to the CFTC for their own monitoring efforts? How compatible and comparable are the transaction monitoring systems in the different markets you represent?

CME Response: To improve the CFTC's oversight effort, we suggest that the CFTC refer all investigations and prosecutions to SRO's when they have adequate authority. We, of course, recognize that some situations dictate that the CFTC act since it may bar an individual or firm from engaging in business throughout the futures industry. Our authority is limited to the CME only. Currently, however, the CFTC appears to make ad hoc determinations respecting whether it will refer or withhold matters.

With respect to the availability of our computer programs for use by the CFTC, we would agree to make them available; however, it may be more effective to build separate systems and then take the best elements of both. With respect to compatibility of information, the CFTC has required us to make our information output compatible with its computer system.

Our transaction monitoring system is quite comparable with the Chicago Board of Trade's system because there was a joint effort to build them. We are unsure of the extent of comparability with other systems; however, at the direction of the CFTC, all futures exchanges have formed a group, known as the Joint Compliance Committee, to enhance detection systems.

4. The industry seems to be split on the question of banning so-called dual trading where brokers trade for themselves as well as for customers. I would like each of you to state your position on this issue and describe what you think would be the practical consequences of banning dual trading? If you favor no restrictions on dual trading, how do you propose that your internal monitoring systems and those of the CFTC prevent possible abuse in these types of transactions?

CME Response: The recommendations of the CME's Special Committee are self-explanatory. These recommendations are not the official CME position. The CME membership is currently engaged in reviewing and refining those suggestions. We must reserve our right to state the CME position until that process is completed.

QUESTIONS SUBMITTED BY SENATOR BOND

1. First, let me commend the Chicago Mercantile Exchange for acting swiftly in reviewing current trading practices and making broad recommendations for change. In reading through your report, I must admit being slightly confused. If public perception is what is driving many of the changes we are hearing today, why would you recommend a ban on dual trading but not on broker associations? What are the benefits and risks associated with broker associations? What limitations are there on trades among members of broker associations?

CME Response: The CME's Special Committee to Review Trading Practices found that the perception of the public customers of our market toward broker associations is that the associations are a positive force on the floor of the exchange. Specifically, broker associations are beneficial because: (1) the capital of the principals is committed to cover all errors by members of the association; (2) well-organized and managed broker associations can quickly respond to changing needs for brokers as the demand for services shifts from pit to pit; (3) such associations are among the few remaining entry points for talented newcomers who lack the capital to acquire a membership or a clearing member guarantee; (4) broker associations provide a training ground for new brokers; and (5) clearing members, in many cases, find it more expedient to deal with one association across the floor.

Approximately 5 years ago, we adopted rules requiring the registration of broker associations. Three years later, after an exhaustive review of data, we adopted restrictions on the amount of trading that could occur within broker associations. Obviously, one of our primary concerns was ensuring a proper balance between restricting members of a group from trading with each other and maintaining liquidity. There was no evidence of trading violations caused by the formation of broker groups. We settled on the following:

(1) A member may not trade for his personal account against other members of his association in an amount in excess of 15 percent of his total personal trades, calculated on a monthly basis; and

(2) A member may not execute customer orders against other members of his association in an amount in excess of 25 percent of the number of orders he executes, calculated on a monthly basis.

2. It seems the Merc has taken somewhat of a lonely position with regard to dual trading. Do you envision your recommendation to ban dual trading in months that have reached Mature Liquidity to be permanent? In other words, if it is being done solely to react to public perception? Two years from now when the CFTC has been reauthorized and life returns to normal on the exchanges, do you envision the ban being lifted?

CME Response: The CME has not yet taken a position on dual trading. The CME has constituted committees comprised of its members to further study the issue.

The CME's Special Committee to Review Trading Practices recommended a ban be implemented so long as market liquidity was not unduly impacted. This decision had nothing to do with reauthorization. Rather, it was recognized that dual trading is a common practice in financial exchanges internationally and is a critical element in assuring futures market liquidity. While violations resulting from dual trading are sufficiently detectable by the CME's surveillance programs, the widely held public perception that dual trading leads to customer abuses must be addressed.

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
WASHINGTON, DC, *June 15, 1989.*

MR. KARSTEN MAHLMANN,
Chairman, Chicago Board of Trade, 141 West Jackson Boulevard, Chicago, Illinois.

DEAR CHAIRMAN MAHLMANN: I have your responses to my followup questions from our May 17, 1989 hearing.

You have corrected the record on two misstatements concerning the magnitude of trade practice penalties assessed by the CBT. However, your testimony on these points created a serious misimpression with the Committee on matters central to the ongoing public debate of recent months.

These misstatements in your testimony are of great concern and weaken the credibility of the testimony.

I am circulating copies of your letter to each member of the Senate Agriculture Committee with your corrections highlighted so that any misunderstanding among our members created by your May 17 testimony can be resolved.

Looking at the responses, I note that, by your own calculation, CBT trade practice fines for 1987 were $125,000—a figure smaller than the CFTC's or GAO's. For 1988, subtracting out the $1.125 million Sanders fine, the total was $325,250.

In light of this data, the premise of my original question from the May 17 hearing stands. According to all accounting systems used—the GAO's, the CFTC's, and your corrected testimony—the CBT issued a significantly lower level of trade practice-related fines during the 2 years prior to last January's disclosures than either the Chicago Mercantile Exchange or the Commodity Exchange, Inc., despite its far greater trading volume.

For the record, then, I restate my original question: Do you acknowledge, based on this data, that the CBT was too lax during this period in detecting and punishing trade practice abuses among its members?

Because of the importance of this issue to the Committee's ongoing inquiry into futures trading practices, we would appreciate your response to this question by no later than June 30, 1989.

Thank you for your cooperation.

Sincerely,

PATRICK LEAHY,
Chairman.

CHICAGO BOARD OF TRADE,
KARSTEN MAHLMANN, CHAIRMAN OF THE BOARD,
June 8, 1989.

The Honorable PATRICK J. LEAHY,
328A Russell Senate Office Building, Washington, DC.

DEAR SENATOR LEAHY: Thank you for permitting the Board of Trade the opportunity to appear before the Committee on Agriculture, Nutrition, and Forestry on May 17, 1989. As a preliminary matter, I would like to correct two apparent misstatements I made at my appearance before your Committee. First, I stated the differences between the Board of Trade's disciplinary statistics and those of the GAO were that the Board of Trade statistics were primarily for wash trading. I should have stated that those cases were primarily prearranged trading cases. Secondly, I may have left you with the impression that the Board of Trade's 1988 statistics did not include findings against Thompson B. Sanders. If so, that impression was incorrect. The Board of Trade's disciplinary statistics did include findings against Mr. Sanders.

We do not disagree with the accuracy of disciplinary statistics submitted by the Commodity Futures Trading Commission or by the General Accounting Office. However, different definitions of trade practice violation and different accounting methods result in different sets of figures as will be explained later in this response.

In accordance with your letter of May 24, 1989, we respectfully submit responses to the additional questions raised.

QUESTION SUBMITTED BY SENATOR LEAHY—HEARING ON COMMODITY FUTURES MARKETS—MAY 17, 1989

DUAL TRADING

I understand that you agree with me that dual trading must exist side-by-side with an effective audit trail System, and that your exchange is or soon will be capable of maintaining a 90 percent audit trail accuracy rate. To guarantee the public that this standard is adhered to, is there any reason that Congress should not ban dual trading in any adequately liquid pit where, in fact, the exchange audit trail system fails to meet the 90 percent standard? Otherwise, we could not guarantee that abuses are being effectively policed.

I assume, for purposes of this question, that the judgment of which trading pits are adequately liquid would be made by the CFTC.

I do agree that we should retain the many benefits which dual or broker trading brings to our markets while controlling potential abuse by enhancing our audit trail system. However, your actual question discusses banning broker trading.

I can't overemphasize that a ban on broker trading, even in "liquid" markets, would seriously damage the performance of those markets, to the detriment of users. Enhanced liquidity is one of several benefits of broker trading. Another is that customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade gives a broker.

In addition, broker trading benefits all potential futures market brokerage customers by maintaining a residual supply of brokerage services to meet a volatile changing demand. This is especially important in markets such as those at the Chicago Board of Trade, MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange whose risk (and demand for hedging brokerage services) varies widely from month to month, season to season, commodity to commodity. The active grain markets at the Exchanges in the summer of 1988 illustrated the importance of having a reserve supply of brokerage services which was demanded by customers on short notice as price volatilities and trading volume shifted sharply from hour to hour, day to day and week to week. Broker traders can respond to the brokerage demand whenever and wherever it occurs. A ban on broker trading would not only hurt market liquidity in all markets, but would also result in lower quality customer order executions and a lower residual supply of brokerage services.

Let me provide you with some specific information on each of these points.

First, a ban on broker trading would reduce market liquidity, even in active contracts. The existence of broker traders in a pit adds more buying and selling capacity over a range of market conditions and makes more risk capital available to service hedging and investment needs of market participants. The institution of broker trading brings more capital to a pit and more traders to provide trading services. Market liquidity is enhanced as risk capital in the pit increases and trading costs are reduced. Risk capital is increased since brokers can establish speculative positions for their own account by broker trading.

There is also an increase in risk capital in a pit due to increased trading opportunities. A trader able to do both brokerage and also trade for his own account is more apt to find a satisfactory number of trading opportunities in a low-volume pit than a trader who is more limited in his trading practices. The broker trader may find that a low-volume pit provides adequate incentive to attract him to offer his trading services (brokerage and market making) in that pit. The increased risk capital which the broker trader brings to the pit lowers the bid/ask spread by providing additional opportunities for all market participants to offset a trade and by creating competition among market makers for a trade on the floor. The process feeds on itself as increased risk capital leads to greater liquidity, and since greater liquidity reduces the risk of committing capital to the market (it is easier to offset a losing trade), more risk capital is attracted. In the absence of broker trading, risk capital in the pit would be decreased, and trading costs would increase, to the detriment of all customers. While these adverse effects may be more noticeable in lower volume pits, they would be felt in *all* markets.

Second, quality of customer order executions would suffer in high and low volume markets alike if broker trading were banned. If broker trading were prohibited, many of the current broker traders would trade only for themselves and cease providing brokerage services. They would leave the brokerage business because they would not be able to draw on their trading skills to provide particularly high quality brokerage service to their customers. Thus, as compared to brokers who do not trade for themselves, they could offer no special incentives to potential customers to attract their business. Furthermore, under a broker trader prohibition, brokers would not be willing or able to employ the techniques used by broker traders because they could not risk a proprietary trade. Broker traders would lose a trading advantage, or "edge", vis-a-vis local traders. The trading disadvantage which broker traders would then have relative to locals in the pit would cause broker traders to become locals trading only for themselves.

With fewer broker traders to compete in the business of offering brokerage services, customer commissions and bid/ask spreads to customers would be expected to rise. Furthermore, as the best broker traders would trade solely for themselves, traders of lesser ability would act as brokers. Customers would be left with fewer brokers, less competition and only those relatively less talented brokers to fill their orders.

Third, the adverse effect of a broker trading ban on the provision of a residual supply of brokerage services in a market of any size can best be understood by a specific example. In the summer of 1988, drought conditions produced substantial increases in agricultural price volatility. This market environment increased the demand for risk management instruments and, therefore, for the execution services of floor brokers. Since most traders who regularly did brokerage were already swamped with the demand for their services, brokerage demands were placed on traders who normally traded strictly for their own account. Having the freedom to broker trade, these traditional locals were able to meet this increased demand.

In the absence of broker trading, with shortages of brokerage services, brokerage fees would have had to rise sufficiently to offset the cost of brokerage start-up in order to elicit new brokerage supply. Floor brokerage fees were raised 20 percent per trade by many FCM's during the busy markets (the fees have since been reduced again to previous levels). The fees could have been raised much higher if reserve brokerage services had not been available from broker traders. Without broker traders, adequate brokerage services might very well not have been available at any cost in an hour, a day or a week if new brokers had to be trained from scratch. Since the practice of broker trading was possible, those start-up costs were minimal for locals already in the pit or in nearby pits. Without broker trading, risk management customers would not only have faced increased bid/ask spreads because of increased uncertainty in the volatile market environment, but higher brokerage fees and higher execution costs as the increased brokerage demand would have more likely been met with inexperienced or minimally experienced traders. Some customers would have had to wait for new brokers to be found. It might not have been possible to immediately meet the demand, even with inexperienced brokers.

PENALTY DATA

In the Supplemental Submission with your testimony, the CBT presented data showing that it had imposed trading practice-related monetary sanctions of $125,500 in 1987 and $1,450,000 in 1988. These figures were quite different from data previously supplied by the CFTC and the GAO.

In order to understand the basis of these statistics, please provide:

—A description of the accounting system used to calculate these statistics, and how you understand it to differ from the methodologies used by the CFTC and the GAO;

—A detailed breakdown of cases included in the 1987 and 1988 data, including the rule violation alleged and the fine imposed in each. We are particularly interested in whether the $1.125 million fine imposed by the CBT against Thompson Sanders is included in the 1988 figure; and

—A listing, based on your accounting system, of the amount of trade practice-related fines imposed by the CBT in 1984, 1985, and 1986.

There appeared to be some confusion with respect to disciplinary statistics of the Chicago Board of Trade at the May 17 hearing by the Senate Committee on Agriculture, Nutrition, and Forestry. Differences were obvious between statistics of the CBOT, Commodity Futures Trading Commission and the General Accounting Office. We respectfully offer the following explanation to further clarify our testimony on that date.

During calendar year 1988, the Chicago Board of Trade initiated 1,464 reviews into trading practices on the Exchange. Of those reviews, 263 resulted from examinations of member firms' handling of customer activity; 1,166 were generated by our Investigations Department; 7 were generated by our Market Surveillance Department; and 28 reviews were conducted on member firm compliance with audit trail requirements.

Of the above-cited trade practice cases, 977 were inquiries generated by computerized surveillance. Of that 977, 28 were reviews of audit trail information, and the remainder from Computerized Trade Reconstruction.

To date, 53 disciplinary actions have been taken, 25 against individuals. One expulsion, 17 years' worth of suspensions and $1,450,000 in fines have also been issued. (See Appendix for details.)

Certain differences are apparent between the CBOT's statistics and the CFTC's. First, we do not disagree with the CFTC's statistics as a result of the method by which they accounted for such statistics. However, in order to judge the effectiveness of a disciplinary program, we believe it is important to start with the origin of an inquiry or investigation and follow it through its life cycle until completion.

This is the method that the Chicago Board of Trade has always used to keep track of the results of its disciplinary activity. Therefore, a case started in 1988 may very well not result in final disciplinary action until 1989. Therefore, our 1988 case statistics often result in final disciplinary action occurring in 1989.

The CFTC's disciplinary statistics, however, were generated on a calendar year basis. The number of disciplinary actions taken in 1988 do not relate to the number of cases initiated in 1988. In all likelihood, the CFTC's 1988 monetary sanctions were a result of cases initiated in 1987 and quite possibly, in some instances, 1986.

The statistics cited by the GAO were supplied by the Chicago Board of Trade and used the methodology utilized by the Board of Trade. However, the 13 individuals sanctioned and $144,000 in fines represents only prearranged trading cases. After consultation with the CFTC and other exchanges through the newly organized Joint Compliance Committee, a more comparable definition of "trade practice" was developed since the original submission of CBOT-defined statistics. Therefore, in an attempt to be consistent with the definition of "trade practice" used by other exchanges, our numbers were adjusted.

All U.S. futures exchanges and the CFTC have already begun meeting to attempt to generate some consistency in these numbers for use by you, your Committee and others. Additional meetings will be held in the future in an attempt to resolve these differences. We will also be meeting with your staff in the near future to further elaborate on these statistics and other issues from our testimony.

It should also be noted that the $1.45 million cited by the Board of Trade includes a $1.1 million fine issued to Thompson B. Sanders. I may have left you with the impression at the hearing that Sanders was not included in the fine total. If so, I sincerely apologize for any misstatement.

I would also wish to stress that the Board of Trade has always put much more emphasis on suspensions than fines. While we could issue higher fines for publicity purposes, we do not believe that that is necessarily an effective deterrent. Issuing only a fine simply puts a price on the violation. Our Exchange has always believed much more strongly in suspensions because a suspension deprives a member of his ability to earn a living, which has a much more serious impact on the violator than a fine. Therefore, in any Committee deliberation of the amount or degree of disciplinary action taken, the level of suspensions plays an important role. (For 1984, 1985 and 1986 statistics and 1987 detail, see Appendix.)

PROPOSALS—CBT, NYMEX, COMEX

Please comment on whether you think the following proposals, which appeared in the April 19 report of the Chicago Mercantile Exchange, special committee should become industry standards:

—That floor compliance staff be authorized to inspect all trading floor documents, including customer orders and trading cards, immediately on the spot;

—That the so-called "fast market" designation, under which a broker's responsibility to fill his customer's orders is lessened during periods of high price volatility, be eliminated. In other words, brokers would be held to the same standard of care in executing customer orders no matter how fast the market is moving.

Before responding to your question regarding the CME's special committee report, we believe it should be emphasized that the Mercantile Exchange committee reports are only proposals at this time. Those proposals will be submitted to various committees of the exchange and still must be voted upon by the Board and membership of the CME. In contrast, changes in the Board of Trade's trade practices have already been adopted in final form by the Exchange and were identified in the supplemental submission to our testimony.

Responding to your specific questions.

1. Rule 545.00 of the Chicago Board of Trade states:

"If a member of the Association, member firm, or other person with trading privileges, is required to submit his books and records, or the books and records of his firm or corporation, or any portion thereof, to the Board, or to any authorized Standing or Special Committee, or to the individual responsible for the supervision of the Office of Investigations and Audits as provided for in Regulation 170.01, or, subject to the provisions of Rule 548.00, to furnish any information to or to appear and testify before, or to cause any of his partners or employees to appear and testify before such Board, or such authorized Committee, or at the request of such individual responsible for the supervision of the Office of Investigations and Audits, it shall be an offense against the Association to fail or refuse to comply with such requirements."

Therefore, any member of the Association is already required to submit his books and records upon request to the Office of Investigations and Audits.

2. CBOT Regulation 320.16 governs "fast" quotations. The "fast" designation means that price fluctuations in the pit are rapid and the volume of business is large and therefore "all prices in the range between those quoted immediately prior to and immediately following the 'FAST' market designation are considered officially quoted whether or not such prices actually appear as trades on Exchange quotations displays and records."

The consequences of "fast" market quotations are that a penetrated limit order may not be able to be executed at the specified limit price. Brokers are always held to a high standard of care no matter how fast the market is moving. A broker is not necessarily absolved of responsibility to fill a limit order in "fast" market conditions.

A possible consequence of a "fast" market is that a broker may be physically unable to obtain the specific limit price requested by the customer because of the rapidly moving market conditions. In such situations, regulations spell out specific procedures for the broker to contact the clearing firm and confirm whether or not an execution is still requested.

The broker's responsibility to fill customer orders is not diminished during "fast" markets. Whether or not the broker should have filled a customer's limit order during such conditions depends upon whether the broker could have been reasonably expected to fill the order. Whether or not he could reasonably have been expected to fill the order depends on market circumstances that occurred at that time, which would include price activity as well as the amount of orders that broker had to fill.

If a dispute arises between the broker, the clearing firm and the customer, a special Arbitration Committee has been established to specifically resolve such disputes.

QUESTIONS SUBMITTED BY SENATOR CONRAD—HEARING ON COMMODITY FUTURES MARKETS—MAY 17, 1989

Questions for the witnesses.

1. What are the possibilities for expanding electronic futures trading? Would such an expansion make it easier to create an audit trail on transactions in order to discourage fraud?

The Chicago Board of Trade is currently developing Aurora, a computerized auction market trading system. This system is expected to be operational next year and would operate during hours when the Board of Trade's physical open outcry markets are closed. The Board of Trade believes, however, that the physical open outcry auction market is the most competitive market trading system yet devised. Due to the large number of buyers and sellers and the requirement that all orders be subject to a competitive bidding and offering process, the public customer receives the most competitive price possible. Insuring competition in the execution of orders insures fairness of price.

The Board of Trade launched a successful open outcry auction market session in the evening hours which has met with great success. If the Board of Trade could create a physical open outcry auction market 24 hours a day, the Exchange would do so.

Electronic futures trading will make it easier to identify when the execution of an order occurs. However, these systems will not necessarily prevent market participants from prearranging transactions outside the market environment. We do not yet have any specific experience with electronic futures trading but trust that such systems hold great promise for the future. We do not believe, however, that such systems are the ultimate answer to scouraging fraud in the marketplace. Fraud is best discouraged by a sophisticated surveillance system coupled with prompt and effective disciplinary action.

2. How effective do you think the Commodities Futures Trading Commission has been in regulating the futures markets? Senator Kerrey brought up the matter of unpaid CFTC fines—what could your exchanges do to help the CFTC collect these fines?

The CBOT believes that the CFTC has been a very effective regulator of the futures markets. It must be kept in mind that the CFTC is a relatively young agency in comparison to the long history of other marketplace regulators. But, throughout its history, the CFTC has overseen dramatic changes in the futures industry and unprecedented increases in trading volume.

Participants in the U.S. futures industry range from the individual to the country elevator to the most sophisticated international market users, including pension funds, insurance companies and even agencies of foreign governments. These market users would not participate in the U.S. futures markets if they lacked confidence in the integrity of such markets. We strongly believe that the confidence worldwide investors demonstrate in the U.S. financial markets, as evidenced by the increasing degrees of participation, would not be possible without the credibility provided these markets by the Exchanges and the CFTC. The CFTC is also serving as the model for regulating the new futures markets which are developing around the world.

To the best of our knowledge, unpaid CFTC fines result from nonexchange traded commodity operations. These so-called "boiler-rooms" simply go out of business once they are shut down by the CFTC. Collecting such fines, therefore, becomes nearly impossible.

To the best of our knowledge, few if any unpaid fines exist from Board of Trade members or Board of Trade member firms. We have not been asked by the CFTC to help in the collection of such fines, but would cooperate if so requested.

3. How would you suggest that the CFTC oversee or regulate your self regulation efforts? Are your newly installed computer procedures to allow transaction monitoring and auditing readily available to the CFTC for their own monitoring efforts? How compatible and comparable are the transaction monitoring systems in the different markets you represent?

In our opinion, the CFTC does an excellent job of overseeing and regulating the Board of Trade's regulatory efforts. The CFTC regularly conducts ever more specific rule reviews of the Exchange's surveillance efforts and makes constructive criticism of our programs. While we do not always agree with the CFTC's recommendations, virtually all recommendations are implemented by the Exchange. Failure to implement such recommendations could result in an enforcement action against the Exchange.

The Chicago Board of Trade's Computerized Trade Reconstruction (CTR) System is available to the CFTC on a next-day basis for the CFTC to conduct their own monitoring efforts. We would respectfully submit that such computer monitoring systems are the most accurate and most detailed of any financial markets in the world.

The transaction monitoring systems are identical across the various markets that trade on the Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange. Differences in surveillance programs, however, may arise depending on the volume of activity and the particular characteristics of specific commodities.

4. The industry seems to be split on the question of banning so called dual trading where brokers trade for themselves as well as for customers. I would like each of you to state your position on this issue and describe what you think would be the practical consequences of banning dual trading. If you favor no restrictions on dual trading, how do you propose that your internal monitoring systems and those of the CFTC prevent possible abuse in these types of transactions?

The importance of broker trading to the futures and options markets at the Chicago Board of Trade, MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange cannot be overstated. Broker trading provides benefits for participants of our markets in three ways. First, broker trading enhances futures market performance by increasing market liquidity, yielding tighter bid/ask spreads and increased market depth. This is particularly important in less liquid pits and in deferred contract months and results in lower costs of order execution for the customer.

Second, customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade gives a broker.

Finally, broker trading benefits all potential futures market brokerage customers by maintaining a reserve supply of brokerage services to meet a volatile changing demand. This is especially important in markets such as those at the three Exchanges whose risk (and demand for hedging brokerage services) varies widely from month to month, season to season, commodity to commodity. The active grain markets at the Exchanges in the summer of 1988 illustrated the importance of having a reserve supply of brokerage services which was demanded by customers on short notice as price volatilities and trading volume shifted sharply from hour to hour, day to day and week to week. Broker traders can respond to the brokerage demand whenever and wherever it occurs.

A ban on broker trading would reduce the quality of our markets to the detriment of our users. The first adverse effect, in practice, of a ban on broker trading would be sharply reduced market liquidity. The existence of broker traders in a pit adds more buying and selling capacity over a range of market conditions and makes more risk capital available to service hedging and investment needs of market participants. The institution of broker trading brings more capital to a pit and more traders to provide trading services. Market liquidity is enhanced as risk capital in the pit increases and trading costs are reduced.

Risk capital is increased since brokers can establish speculative positions for their own account by broker trading. There is also an increase in risk capital in a pit due to increased trading opportunities. A trader able to do both brokerage and also trade for his own account is more apt to find a satisfactory number of trading opportunities in a low volume pit than a trader who is more limited in his trading practices. The broker trader may find that a low volume pit provides adequate incentive to attract him to offer his trading services (brokerage and market making) in that pit. The increased risk capital which the broker trader brings to the pit lowers the bid/ask spread by providing additional opportunities for all market participants to offset a trade and by creating competition among market makers for a trade on the floor.

The process feeds on itself as increased risk capital leads to greater liquidity, and since greater liquidity reduces the risk of committing capital to the market (it is easier to offset a losing trade), more risk capital is attracted. In the absence of broker trading, risk capital in the pit would be decreased, and trading costs would increase, to the detriment of all customers.

A second practical consequence of a dual trading ban would be a reduction in the quality of customer order executions. If broker trading were prohibited, many of the current broker traders would trade only for themselves and cease providing brokerage services. They would leave the brokerage business because they would not be able to draw on their trading skill to provide particularly high quality brokerage service to their customers. Thus, as compared to brokers who do not trade for themselves, they could offer no special incentives to potential customers to attract their business.

Furthermore, under a broker trader prohibition, brokers would not be willing or able to employ the techniques used by broker traders because they could not risk a proprietary trade. Broker traders would lose a trading advantage, or "edge", vis-a-vis local traders. The trading disadvantage which broker traders would then have relative to locals in the pit would cause broker traders to become locals trading only for themselves. With fewer broker traders to compete in the business of offering brokerage services, customer commissions and bid/ask spreads to customers would be expected to rise.

Thus, as the best broker traders would trade solely for themselves, traders of lesser ability would act as brokers. Customers would be left with fewer brokers, less competition and only those relatively less talented brokers to fill their orders. The quality of their order executions would clearly suffer.

A third kind of adverse impact which market users would be forced to bear under a dual trading ban relates to the reduction of reserve brokerage services. The practical effect of a broker trading ban on the provision of a reserve supply of brokerage services can best be understood by a specific example. In the summer of 1988, drought conditions produced substantial increases in agricultural price volatility. This market environment increased the demand for risk management instruments and, therefore, for the execution services of floor brokers. Since most traders who regularly did brokerage were already swamped with the demand for their services, brokerage demands were placed on traders who normally traded strictly for their own account. Having the freedom to broker trade, these traditional locals were able to meet this increased demand.

In the absence of broker trading, with shortages of brokerage services, brokerage fees would have had to rise sufficiently to offset the cost of brokerage start-up in order to elicit new brokerage supply. Floor brokerage fees were raised 20 percent per trade by many FCM's during the busy markets (the fees have since been reduced again to previous levels). The fees could have been raised much higher if reserve brokerage services had not been available from broker traders. Without broker traders, adequate brokerage services might very well not have been available at any cost in an hour, a day or a week if new brokers had to be trained from scratch. Since the practice of broker trading was possible, those start-up costs were minimal for locals already in the pit or in nearby pits.

Without broker trading, risk management customers would not only have faced increased bid/ask spreads because of increased uncertainty in the volatile market environment, but higher brokerage fees and higher execution costs as the increased brokerage demand would have more likely been met with inexperienced or minimally experienced traders. Some customers would have had to wait for new brokers to be found. It might not have been possible to immediately meet the demand, even with inexperienced brokers. Had a dual trading ban been in force during such market conditions, the practical consequences would have been severe.

QUESTIONS SUBMITTED BY SENATOR BOND—HEARING ON COMMODITY FUTURES MARKETS—MAY 17, 1989

1. I am interested in your thoughts on the Merc's recommendation to ban dual trading on mature, highly liquid contracts. How would this type of ban impact the CBOT?

Enhanced liquidity is one of several benefits of broker trading. Another is that customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade gives a broker. In addition, broker trading benefits all potential futures market brokerage customers by maintaining a residual supply of brokerage services to meet a volatile changing demand.

This is especially important in markets such as those at the Chicago Board of Trade, MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange whose risk (and demand for hedging brokerage services) varies widely from month to month, season to season, commodity to commodity. The active grain markets at the Exchanges in the summer of 1988 illustrated the importance of having a reserve supply of brokerage services which was demanded by customers on short notice as price volatilities and trading volume shifted sharply from hour to hour, day to day and week to week.

Broker traders can respond to the brokerage demand whenever and wherever it occurs. A ban on broker trading would not only hurt market liquidity in all markets but would also result in lower quality customer order executions and a lower residual supply of brokerage services.

First, a ban on broker trading would reduce market liquidity, even in active contracts. The existence of broker traders in a pit adds more buying and selling capacity over a range of market conditions and makes more risk capital available to service hedging and investment needs of market participants. The institution of broker trading brings more capital to a pit and more traders to provide trading services. Market liquidity is enhanced as risk capital in the pit increases and trading costs are reduced. Risk capital is increased since brokers can establish speculative positions for their own account by broker trading.

There is also an increase in risk capital in a pit due to increased trading opportunities. A trader able to do both brokerage and also trade for his own account, is more apt to find a satisfactory number of trading opportunities in a low volume pit than a trader who is more limited in his trading practices. The broker trader may find that a low volume pit provides adequate incentive to attract him to offer his trading services (brokerage and market making) in that pit. The increased risk capital which the broker trader brings to the pit lowers the bid/ask spread by providing additional opportunities for all market participants to offset a trade and by creating competition among market makers for a trade on the floor.

The process feeds on itself as increased risk capital leads to greater liquidity, and since greater liquidity reduces the risk of committing capital to the market (it is easier to offset a losing trade), more risk capital is attracted. In the absence of broker trading, risk capital in the pit would be decreased, and trading costs would increase, to the detriment of all customers. While these adverse effects may be more noticeable in lower volume pits, they would be felt in *all* markets.

Second, quality of customer order executions would suffer in high and low volume markets alike if broker trading were banned. If broker trading were prohibited, many of the current broker traders would trade only for themselves and cease providing brokerage services. They would leave the brokerage business because they would not be able to draw on their trading skill to provide particularly high quality brokerage service to their customers. Thus, as compared to brokers who do not trade for themselves, they could offer no special incentives to potential customers to attract their business.

Furthermore, under a broker trader prohibition, brokers would not be willing or able to employ the techniques used by broker traders because they could not risk a proprietary trade. Broker traders would lose a trading advantage, or "edge", vis-a-vis local traders. The trading disadvantage which broker traders would then have relative to locals in the pit would cause broker traders to become locals trading only for themselves. With fewer broker traders to compete in the business of offering brokerage services, customer commissions and bid/ask spreads to customers would be expected to rise. Furthermore, as the best broker traders would trade solely for themselves, traders of lesser ability would act as brokers. Customers would be left with few brokers, less competition and only those relatively less talented brokers to fill their orders.

Third, the adverse effect of a broker trading ban on the provision of a residual supply of brokerage services in a market of any size can best be understood by a specific example. In the summer of 1988, drought conditions produced substantial increases in agricultural price volatility. This market environment increased the demand for risk management instruments and, therefore, for the execution services of floor brokers. Since most traders who regularly did brokerage were already swamped with the demand for their services, brokerage demands were placed on traders who normally traded strictly for their own account. Having the freedom to broker trade, these traditional locals were able to meet this increased demand.

In the absence of broker trading, with shortages of brokerage services, brokerage fees would have had to rise sufficiently to offset the cost of brokerage start-up in order to elicit new brokerage supply. Floor brokerage fees were raised 20 percent per trade by many FCM's during the busy markets (the fees have since been reduced again to previous levels). The fees could have been raised much higher if reserve brokerage services had not been available from broker traders. Without broker traders, adequate brokerage services might very well not have been available at any cost in an hour, a day or a week if new brokers had to be trained from scratch.

Since the practice of broker trading was possible, those start-up costs were minimal for locals already in the pit or in nearby pits. Without broker trading, risk management customers would not only have faced increased bid/ask spreads because of increased uncertainty in the volatile market environment, but higher brokerage fees and higher execution costs as the increased brokerage demand would have more likely been met with inexperienced or minimally experienced traders. Some customers would have had to wait for new brokers to be found. It might not have been possible to immediately meet the demand, even with inexperienced brokers.

2. I know that your exchange has commissioned a study on the effects of dual trading. If public perception is as important as everyone seems to believe, do you think another study will be acceptable?

The study of broker trading which the Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange have recently submitted to the CFTC demonstrates that there are two principal benefits which broker trading brings to the futures markets. First, because broker traders are permitted to trade for their own accounts, they are able to engage in trading strategies in the course of executing a customer order which result in a better price for the customer than can be obtained by a broker who does not trade for himself. The study provides detailed examples of these trading strategies, describes the specific advantages customers derive from broker trading and presents letters from customers explaining why they prefer to have their orders executed by broker traders.

The second benefit of broker trading is that it adds substantial liquidity or depth to the market. The study shows that a significant share of the risk capital available in the markets examined is provided by broker traders. Since broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets, and more capital, and this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity provided by broker traders (for the benefit of *all* market users), presents further statistics describing the extent of broker trading activity at the three Exchanges, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

It became clear, however, as we reviewed results that this must be viewed as a preliminary study, since a thorough study of the contribution of broker trading at the Exchanges would require more time than was allotted by the CFTC. To ensure that the study can impact public perception, the Exchanges have commissioned Professor Sanford J. Grossman to analyze the role of broker trading in the futures and broader financial markets. Dr. Grossman, the John F. Weinberg Professor of Economics at Princeton University, has conducted a number of studies of the futures and equities markets including research for the New York Stock Exchange as well as the Chicago Board of Trade. He is eminently qualified to examine not only the mechanisms by which broker trading brings these benefits to the futures markets but also the extent of the practice and its contribution to other domestic and international financial markets.

We fully expect that this independent study will provide new insights on broker trading which will help clarify its role in the futures markets for the benefit of the exchanges, the Members of Congress and the public. The additional information and clarity which the study will provide should remedy some of the misunderstanding and misconceptions which, we feel, underlie much of the public debate concerning the practice of broker trading.

I trust this fully responds to the questions raised. If you, other Senators or members of your staff have additional questions, please do not hesitate to contact us.

Sincerely,

Karsten Mahlmann,
Chairman of the Board.

Attachment.

APPENDIX

1988 DISCIPLINARY ACTION FOR TRADE PRACTICE MATTERS

File and name	Regulations	Decision
88-INV-01—Preliminary charges outstanding.		
88-INV-05—Dean Dziuba	332.00, 332.01, 350.05(e), 350.05(i), 504.00.	10 days—$5,000.
88-INV-06:		
Daniel Donzelli	293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
Donald Eberhardt	211.00, 293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
88-INV-07—Preliminary charges outstanding.		
88-INV-11:		
John Zumpano	301.05, 500.00, 504.00, MidAm 409(G), 701(A), 701(P).	10 days—$3,000.
Jeffrey Lonigro	301.05, 500.00, 504.00, MidAm 409(G), 701(A), 701(P).	10 days—$3,000.
88-INV-12—Morgan Stanley	350.05(e), 350.05(f), 504.00	C&D—$15,000.
88-INV-15—Hearing pending decisions to date:		
Jesse Herr	331.01, 350.05(h), 310.00	2 days—$2,000.
Paul Lopata	331.01, 350.05(h), 310.00	2 days—$2,000.
Thomas Stack	331.01, 350.05(h), 310.00	2 days—$2,000.
Staley Comm.	500.00	$7,500.
88-INV-17—Cary Goodman	293.00, 293.05, 504.00	5 days—$2,000.
88-INV-20—Preliminary charges outstanding.		
88-INV-21—Preliminary charges outstanding.		
88-INV-22:		
Patrick Bratta	310.00, Ruling 311.00A, 350.05, (h), 332.00, 332.01, 332.02, 350.05(f), 350.05(i), 500.00, 501.00, 504.00, 506.00.	4 years—$25,000.
Scott Bremner	310.00, 332.00, 332.01, 332.02, 350.05(f), 350.05(i), 500.00, 501.00, 504.00, 506.00.	10 years—$50,000.

1988 DISCIPLINARY ACTION FOR TRADE PRACTICE MATTERS—Continued

File and name	Regulations	Decision
Daniel Hayes	310.00, 332.00, 332.01, 332.02, 350.05(f), 350.05(i), 500.00, 501.00, 504.00, 506.00.	2 years.
Robert Kinkade	350.05(i), 500.00, 504.00, 506.00.	120 days—$10,000.
Thompson Sanders	301.00, 301.01, 310.00, Ruling 311.00A, 350.05(h), 332.00, 332.01, 332.02, 350.05(f), 350.05(i), 500.00, 501.00, 504.00, 505.00, 506.00.	Explusion permanently barred—$1,125,000.
David Schremser	310.00, Ruling 311.00A, 350.05(h), 332.00, 332.01, 332.02, 350.05(f), 350.05(i), 500.00, 501.00, 504.00, 506.00.	15 days—$5,000.
John P. Sutor	500.00, 504.00, 506.00	6 months—$10,000.
88-INV-23—Chase Manhattan Bank	350.05(f), 350.05(i)	C&D—$10,000.
88-INV-26—Stanley Bedows	352.01, 500.00	$10,000.
88-INV-27—Duane Scheck	291.00, 290.02	1 day—$3,000.
88-INV-36:		
Index futures	332.00, 332.01, 350.05(f), 504.00.	Reprimand.
Kevin Doyle	332.00, 332.01, 350.05(f), 504.00.	Reprimand.
88-INV-37:		
Ralph Hughes	310.00, 332.00, 504.00	3 days—$1,000.
James Kardelis	310.00, 332.00, 504.00	$500.
88-EX-01—Cargill Investor Services, Inc.	465.01, 545.02	$500.
88-EX-02—Paine Webber, Inc.	465.01, 545.02	$500.
88-EX-24—Whitehall Futures Corp.	545.02	$5,000.
88-EX-34—Shearson Lehman Hutton, Inc.	465.01, 545.02	
88-EX-101—Stotler and Company	465.01	$500.
88-EX-103—Stotler and Company	465.01	$500.
88-EX-109—Stotler and Company	465.01	$500.
88-EX-253—Stotler & Company	465.01	$1,000.
88-RRR-42:		
ARI Grain Co.	545.02	$500.
Donald W. Herr	545.02	$500.
Bear Stearns & Co., Inc.	545.02	$500.
88-RRR-75:		
Goldman Sachs & Co.	545.02	$500.
Drexel Burnham Lambert Incorporated	545.02	$500.
88-RRR-86:		
James Brennan	519.02	$250.
Roger Kuperman	519.02	$250.
Robert J. Griffin	519.02	$250.
John J. Ott, Jr.	519.02	$250.
Dale A. Cowel	519.02	$250.
James F. DeMunno	519.02	$250.
Craig A. Sulak	519.02	$250.
88-MSI-01:		
Archer-Daniels-Midland Co.	1143.01	$500.
Henning & Krajewski Trading Co.	1143.01	$500.
Staley Commodities, Inc.	1143.01	$500.
88-MSI-11—First Options of Chicago, Inc.	2442.01, 2449.03	$10,000.
88-MSI-11—Bear, Stearns & Co., Inc.	2442.01, 2449.03	$50,000 (preliminary).
88-MSI-11—Shearson Lehman Hutton, Inc.	2442.01, 2449.03	$10,000.
88-MSI-11—Paine Webber, Inc.	2442.01, 2449.03	$50,000 (preliminary).

1988 DISCIPLINARY ACTION FOR TRADE PRACTICE MATTERS—Continued

File and name	Regulations	Decision
88-MSI-11—Drexel Burnham Lambert, Inc.	2442.01, 2449.03	$15,000 (preliminary).
88-MSI-11—Virginia Trading Corp.	2442.01, 2449.03	$5,000.
88-MSI-21—First Options of Chicago, Inc.	444.01	$5,000.
Total fines for trade practice matters		$1,450,250.
Total fines for other matters (see schedule)		$107,500.
Total 1988 fines		$1,557,750.

1988 DISCIPLINARY ACTION FOR OTHER MATTERS

File and name	Regulations	Decision
88-INV-01—William Davis	519.00	$1,000.
88-INV-04—Edward Golz	519.00, 504.00	5 days—$5,000.
88-INV-09—Robert Fanning, Jr.	519.00, 504.00	15 days—$5,000.
88-INV-13—David Fisher	519.00, 504.00	$1,000.
88-INV-14:		
Nicholas LaPorte	519.00	$500.
John Pelling, Jr.	519.00, 504.00	$1,000.
88-INV-16—Daniel Ragins	519.00	$500.
88-INV-29—Steven Jacobson	519.00	$500.
88-INV-33:		
Sandor Kardos	519.00, 504.00	1 day—$1,000.
William McNamee	519.00, 504.00	5 days—$3,000.
88-EX-06—Barnes & Company	403.07, 431.02, 490.05	$1,000.
88-EX-14—Kidder, Peabody & Co. Incorporated	403.07	$500.
88-EX-42—Yamaichi Intl., Inc.	431.02, 545.02	$1,000.
88-EX-149—Balfour, Maclaine Inc.	545.01	$1,000.
88-EX-150—Balfour, Maclaine Inc.	545.01	$1,000.
88-EX-184—Balfour, Maclaine Inc.	545.01	$1,000.
88-EX-185—Balfour, Maclaine Inc.	545.01	$1,000.

1988 DISCIPLINARY ACTION ON OTHER MATTERS

File and name	Regulations	Decision
88-FIN-09—Bear, Stearns & Co.	403.07, 211, 212	$500
88-FIN-18—Prudential-Bache Securities, Inc.	403.07, 211, 212	5,000
88-FIN-48—Goldman, Sachs & Co.	403.07, 211, 212	500
88-FIN-50—Henning & Krajewski Trading Co.	403.07, 211, 212, 203, 545.02	1,000
88-FIN-57—Zen-Noh	249.01(b)(ii)	500
88-FIN-66—Citicorp Futures Corp.	249.01(b)(ii)	500
88-FIN-71—Zen-Noh Unico America	545.03	500
88-FIN-101—Marubeni America Corp.	545.03	500
88-FIN-104—Prudential-Bache Securities, Inc.	403.07, 251 G, 250 B (7)	1,000
88-FIN-105—Shearson Lehman Hutton, Inc.	403.07, 250 B (7)	1,000
88-FIN-108—Toyomenka, Inc.	545.03	500
88-FIN-119—Pillsbury Company	545.03	500
88-FIN-120—Whitehall Futures Corp.	545.03	500
88-FIN-121—Shun-Loong—Bear Stearns, Ltd.	545.03	500
88-FIN-129—NCZ Commodities, Inc.	285.05	1,000
88-MSI-02—David Gholson	495.01	10,000
88-MSI-03—Robert J. Pierce	495.01	500
88-MSI-04—Robert J. Pierce	495.01	2,500
88-MSI-10—David Gholson	495.01	20,000
88-MSI-13—Robert J. Pierce	495.01	15,000

1988 DISCIPLINARY ACTION ON OTHER MATTERS—Continued

File and name	Regulations	Decision
88-MSI-14		
88-MSI-16		
88-MSI-18—LIT America, Inc.	495.01	500
88-MSI-19		
87-MSI-25—Richardson Greenshields Securities, Inc.	426.01, 495.01, 416.03	20,000
Total 1988 fines for other matters		107,500

1987 DISCIPLINARY ACTION ON TRADE PRACTICE MATTERS

File and name	Regulations	Decision
87-INV-04—Jeffrey Purcell	330.01, 504.00	10 days—$7,500.
87-INV-08:		
Peter Donaghue	320.15, 332.00, 332.01, 350.05(d), 350.05(e), 350.05(f), 350.05(g), 350.05(i), 500.00, 504.00.	60 days—$10,000.
Terry Funcik	332.00, 332.01, 350.05(e), 350.05(f), 350.05(i), 500.00, 504.00.	10 days—$5,000.
87-INV-10:		
Timothy Staggs	301.05, 350.05(f), 501.00, 500.00, 504.00.	Permanently barred.
Larry Maxfield	332.00, 332.01, 350.05(f), 501.00, 504.00, 500.00.	60 days—$10,000.
87-INV-18:		
Patrick Kenny	350.01, 423.01, 500.00, 506.00, 504.00.	C&D—$10,000.
Geldermann	350.01, 421.00, 423.03, 465.01, 545.01, 545.02, 504.00.	$7,000.
87-INV-20:		
Samuel Kletter	332.01, 350.05(f), 519.00	3 days—$3,500.
Laurence Coleman	332.01, 350.05(f)	$1,000.
87-INV-22:		
Richard Latz	211.00	Reprimand.
Edward Keiser	211.00	Reprimand.
Wayne Parman	293.00, 293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
John Hawke	293.00	Reprimand.
Therese Walsh	293.00, 293.02, 293.03, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
Roy Huckabay	293.00, 293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
Gregory Pickup	293.00, 293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
Mark Nesbitt	293.00, 301.05, Appendix 3B	Reprimand.
Gustave Nesvick	211.00, 293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B, 504.00.	Reprimand.
Richard Kresse	293.00, 293.02, 293.03, 293.07, 293.08, 293.09, 504.00.	30 days—$5,000.
Chris Shepard	293.02, 293.03, 293.07, 293.08, 293.09, 301.05, Appendix 3B.	Reprimand.
John Frazier	293.00, 301.05, Appendix 3B	Reprimand.
John Frazier	504.00	Reprimand.
87-INV-23:		
Andrew Kern	301.05	3 days—$3,000.

1987 DISCIPLINARY ACTION ON TRADE PRACTICE MATTERS—Continued

File and name	Regulations	Decision
Robert Kern	293.00, 293.02, 293.03, 293.04, 293.07, 293.09, 301.05, Appendix 3B.	3 days—$1,000.
Chris Gilmore	301.12	$1,000.
87–INV–24:		
Anthony Gibbons	332.00, 350.05(e), 350.05(f), 350.05(i).	$7,500.
Chris Ohmura	332.00, 350.05(e)	Reprimand.
87–EX–08—Rosenthal & Company	286.00, 431.02, 465.01, 425.01	$20,000.
87–EX–12—Prudential-Bache Securities, Inc.	403.07, 465.01	$25,000.
87–EX–131—Geldermann, Inc.	465.01	$500.
87–EX–251—Prudential-Bache Securities, Inc.	465.01	$1,000.
87–EX–279—Iowa Grain Company	465.01, 545.02	$1,000.
87–EX–262—Stotler and Company	465.01	$500.
87–EX–302—Stotler and Company	465.01	$500.
87–MSI–01—Donaldson Lufkin & Jenrette Securities Corporation	1743.01, 504.00	$5,000.
Total fines on trade practice matters		$125,000.
Total fines on other matters (see Schedule)		$92,050.
Total fines for 1987		$217,050.

1987 DISCIPLINARY ACTION ON OTHER MATTERS

File and name	Regulations	Decision
87–INV–01:		
Thomas Putzler	519.00	$500.
Mark Sandler	519.00	$50.
87–INV–02—Gary Laybov	519.00, 504.00	$2,000.
87–INV–11—Michael Ryan	519.00, 504.00	20 days.
87–INV–13—James Franson	519.00, 504.00	20 days.
87–INV–15—Thompson Sanders	350.03, 519.00, 504.00	$500.
87–INV–21—David Brach	519.00, 504.00	3 days—$2,500.
87–EX–51—Norman Kern & Co.	403.07, 545.02	$5,000.
87–EX–43—Staley Commodities, Inc.	545.02	$2,000.
87–EX–52—The Nikko Securities Co. International Inc.	403.07	$5,000.
87–EX–44—Drexel Burnham Lambert Incorporated	403.07	$1,000.
87–EX–40—B.A. Futures, Inc.	431.02	$1,000.
87–FIN–61—Woodstock, Inc.	286.00, 504.00	$15,000.
87–FIN–75—Smith Barney, Harris Upham & Co., Inc.	403.07, 211, 212	$500.
87–FIN–79—Merrill Lynch Futures, Inc.	403.07, 211, 212	$1,000.
87–FIN–89—Norman Kern & Co.	403.07, 203, 211	$5,000.
88–FIN–32—Citicorp Futures Corp.	249.01(b)(ii)	$500.
88–FIN–36—Nabisco Brands, Inc.	249.01(b)(ii)	$500.
88–FIN–56—Nissho-Iwai America Corp.	249.01(b)(ii)	$500.
88–FIN–55—BA Futures, Inc.	403.07, 303	$500.
87–MSI–06—E.F. Hutton & Co., Inc.	495.01	$1,000.
87–MSI–07—First Options of Chicago, Inc.	444.01	$500.
87–MSI–08—Robert Van Mell	444.01	$500.
87–MSI–10—Robert Newcomer	495.01	$5,000.
87–MSI–18—Scott Bremner/J. Syverson	495.01	$5,000. $1,000.
87–MSI–21—Kevin Knox	495.01	$500.
87–MSI–22—David Gholson	495.01	$500.
87–MSI–29—Shatkin Trading Company	545.01, 1049.03, 1243.00	$3,000.
87–MSI–33—First Options of Chicago, Inc.	444.01	$1,000.
87–MSI–37—Balfour, Maclaine Inc.	545.01, 545.02	$1,000.
87–MSI–38—Stotler & Company	545.01, 545.02	$2,500.
87–MSI–39—George Hanley	495.01	$5,000.
87–MSI–42—George Hanley	495.01	$5,000.

1987 DISCIPLINARY ACTION ON OTHER MATTERS—Continued

File and name	Regulations	Decision
87–MSI–43—Donaldson Lufkin & Jenrette Securities Corporation	1743.01(D)	$1,000.
87–MSI–45—George Hanley	495.01	$10,000.
87–MSI–48—David Gholson	495.01	$1,000.
87–MSI–49—George Hanley	495.01	$2,500.
87–MSI–51—E.F. Hutton & Co., Inc.	842.01	$1,000.
87–MSI–52—The Chicago Corp.	1049.04	$500.
87-MSI–53—Refco, Inc.	1049.04	$500.
Total 1987 fines for other matters		$92,050.

CBOT DISCIPLINARY SANCTIONS

	Fines	Suspensions
1984	$405,500	174 consecutive business days, one expulsion, 3 permanently barred.
1985	501,500	180 consecutive business days, 1½ years, 1 permanently barred.
1986	472,900	613 consecutive business days, 20 years, 3 reprimands, 1 expulsion, 1 registration suspension, 2 permanently barred.

NEW YORK MERCANTILE EXCHANGE,
OFFICE OF THE CHAIRMAN,
June 8, 1989.

VIA FEDERAL EXPRESS

The Honorable PATRICK J. LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, SR–328A, Russell Senate Office Building, Washington, DC.
Attn: Betsy Paul.

DEAR CHAIRMAN LEAHY: On behalf of the New York Mercantile Exchange, I am pleased to forward the Exchange's responses to the additional questions submitted for the record in association with the May 17, 1989 hearing conducted by the Committee.

The Exchange will be pleased to assist the Committee with whatever further information may be useful as this process continues.

Very truly yours,

Z. LOU GUTTMAN.

[The responses for New York Mercantile Exchange follow:]

I. QUESTIONS SUBMITTED BY SENATOR LEAHY—HEARING ON COMMODITY FUTURES MARKETS, MAY 17, 1989

A. DUAL TRADING

Question. I understand that you agree with me that dual trading must exist side-by-side with an effective audit trail system, and that your exchange is or soon will be capable of maintaining a 90 percent audit trail accuracy rate. To guarantee the public that this standard is adhered to, is there any reason that Congress should not ban dual trading in any adequately liquid pit, where in fact, the exchange audit trail system fails to meet the 90 percent standard? Otherwise, we could not guarantee that abuses are being effectively policed.

I assume, for purposes of this question, that the judgment of which trading pits are adequately liquid would be made by the CFTC.

Answer. The Exchange concurs that an accurate audit trail is essential to police the markets for potential trading abuses. The Exchange also believes that a 90 percent accuracy level in audit trail creation is an appropriate industry-wide goal.[1] However, for the reasons set forth below, the Exchange does not believe that the two-step test involving audit trail "accuracy" and "adequacy of trading pit liquidity" is the appropriate method to determine whether dual trading should be permitted in any particular contract.

As a test for audit trail accuracy, the 90 percent level should serve as a goal or a guideline, rather than as an absolute basis for determining regulatory requirements. As the Congress is aware, different exchanges use different means for creating their audit trail. NYMEX's audit trail is created by the pit card submission procedure—a procedure which requires transaction-by-transaction submission to the Exchange of the hard data used to create the audit trail.[2] NYMEX believes that the pit card system is the most effective means to create an accurate, tamper-resistant audit trail, yet it is the most burdensome on floor traders. The differences among systems may require different testing methods to make a 90 percent "accuracy" level meaningful.

At the risk of being repetitious, the pit card system records transactions in the following manner. After each transaction is executed on the floor of the Exchange, the seller is required to submit to an Exchange official a pit card, identifying the buying and selling brokers, the commodity, month, quantity and price of the transaction. The Exchange official immediately time-stamps all pit cards upon receipt and that time-stamp becomes the official time of the trade.

Some other systems rely upon the floor trader to manually enter a trade time on a trading record. Others impute trade times through computer programs. Both of these types of systems rely upon broker entries periodically submitted to the exchange, every 15 minutes, 30 minutes or even longer. The brokers' trading records contain information for all transactions within the bracket period.

In terms of audit trail accuracy, there are several benefits of the pit card system, all of which derive from one simple fact—pit card times are real trade transaction times. Pit card times are not imputed by computer programs based on assumptions and probabilities. They are not broker entries of execution times. They are time-clocked by Exchange officials, independently recording the time of each transaction. Because the pit card must be submitted directly after a trade execution, the ability of a broker to alter or amend that information without alerting the Exchange and documenting the basis for the change is eliminated. Other systems permit brokers to retain, review and create or recreate their records for a substantial period after the transaction without detection.

The benefits of the pit card system bring with them procedural difficulties in achieving the same empirical "accuracy" rates as other systems. Under the pit card system, a trader must: (1) complete his trade, (2) write-up the pit card, (3) submit it to an Exchange official, *and* (4) have it time-stamped, all within 60 seconds. To illustrate: suppose a broker has a market order to sell 100 contracts of crude oil futures for a customer. As he starts the process of execution, he is able to fill only 20 contracts with one broker at an initial price and, therefore, continues to offer to execute the balance of the order. Within moments, his offer is taken, in partial fills of 20 lots each, by 4 other brokers. Assuming that the process took less than one minute to complete the execution of the customer order from the first partial fill through the last, there is still a possibility to comply with the one-minute time-stamping requirement.[3] At this point, the broker must begin to write pit cards and submit them to the Exchange. Finally, still within the 60 second period, the Exchange official must retrieve the card and time-stamp it, otherwise compliance with the one-minute standard technically will not be achieved.

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[1] The Exchange has recently implemented a new computer program that measures the Exchange's compliance with the one-minute time-stamping standard. A study of five recent trading days shows an average 85 percent accuracy rate with a high of 87 percent. Because the program identifies individuals who failed to meet the one-minute standard, it should improve enforcement efforts and enable the Exchange to improve its overall performance to achieve the 90 percent goal.

[2] The Exchange's audit trail also has several other components to reconstruct trading activity and detect improper conduct, including order tickets, transfer sheets and the Time and Sales Report.

[3] Although the broker could stop the execution process after the first partial fill to submit a pit card, this would be inefficient and might result in significant economic harm to his customer.

Under other audit trail creation methods, the broker theoretically has at least 15 to 30 minutes to complete all of the steps described above. First, there is no effect on "accuracy" if the fill is not completed within 60 seconds. More importantly, actual timeliness in creating the audit trail records is not detecting by "accuracy" testing methods provided that within the 15 to 30 minute period (or longer) afterward the broker completes a trading card identifying his recollection of the time of the trade.

In sum, even though the pit card system results in the most timely and accurate audit trail creation, its benefits may not be apparent through score lowest in an empirical "accuracy" test. NYMEX submits that a pit card audit trail record, even if some cards are time-stamped in a 2-minute period after execution, for example, is a more accurate and reliable record than a 90 percent "accurate" record created by other systems. Because a black/white 90 percent objective standard for audit trail accuracy might mean different things in different markets, its uniform application may not result in the desired customer protection benefits.

There are additional considerations in connection with the proposal that should be addressed. If it was adopted, procedures would need to be developed to address the appropriate time period of measurement for audit trail "accuracy." As stated in their report, the Exchange's Regulatory Review Task Force believed that dual trading should not be eliminated or restricted without further study as to such action's potential effect on liquidity and market efficiency. It is clear that such a position would apply equally to the effects of a ban (even if temporary) for the failure to meet an "accuracy" criterion. More importantly, several other questions arise. For example, would there be a ban for a failure to meet the criterion for 1 month in 12? How long would the ban last? How much advance notice would be given? Should there be a ban if the cause of the aberration was identified, addressed, and, if appropriate, the individuals whose submissions caused the aberration prosecuted? How would spread trading between dual trading months and nondual trading months be handled?

Finally, assuming for purposes of this discussion that the CFTC could determine whether a trading pit was "adequately liquid," in reality, the Task Force's report suggested that (1) a valid determination of "adequately liquid" may not be achievable by any person or entity, and (2) even in liquid contracts, there are periods of slow or active trading during which the additional liquidity provided by dual trading could enhance market efficiency. Thus, the Task Force was unwilling, without further study, to accept the notion of "adequate liquidity" for the purpose of limiting or restricting dual trading. The Exchange would caution against legislation or regulation on this subject, even if tied to the required audit trail, until the appropriate studies on market liquidity can be conducted.

B. PROPOSALS—CBT, NYMEX, COMEX

Question. Please comment on whether you think the following proposals, which appeared in the April 19 report of the Chicago Mercantile Exchange special committee, should become industry standards:

—That floor compliance staff be authorized to inspect all trading floor documents, including customer orders and trading cards, immediately on the spot;

—That the so-called "fast market" designation, under which a broker's responsibility to fill his customer's orders is lessened during periods of high price volatility, be eliminated. In other words, brokers would be held to the same standard of care in executing customer orders no matter how fast the market is moving.

Answer.

1. Inspection of Floor Trading Documents

The Exchange believes that this proposal has merit, although the power must be judiciously employed. Periodic, unannounced inspections (or the threat thereof) whether randomly conducted or conducted when suspicious activity is observed, can deter wrongful conduct and detect such conduct before records can be altered that might mask it.

The NYMEX Compliance Department already has this power. NYMEX Rule 8.00(D) provides that "Members and Member Firms shall make their books and records available to the Compliance Department and shall respond to all inquiries of the Compliance Department *at the time, place and in the manner designated by the Compliance Department.*" (Emphasis added.)

The benefits of spot inspections, including the time and place of such inspections, must be balanced against the disruptive reaction that they can create. For example, removing an individual from the trading ring arbitrarily, or upon the mere suspicion of wrongful conduct, has the potential to harm financially both the trader with his own positions and the trader attempting to execute customer orders. In addition, such action would likely cause commotion in the trading ring itself distracting market participants and decreasing market efficiency.

Accordingly, the power to conduct spot inspections must be exercised cautiously.

2. Fast Market

NYMEX has no "fast market" designation. Under NYMEX Rule 6.16, brokers are held to the same standards of care at all times (other than openings and closings). Thus, NYMEX Rule 6.16(B) provides, in part:

Rule 6.16—Obligation of Floor Brokers

(B) Floor brokers, in the execution of orders, must exercise reasonable care and skill given the then current market condition, market values and the nature of the order.

II. QUESTIONS SUBMITTED BY SENATOR CONRAD—HEARING ON COMMODITY FUTURES MARKETS, MAY 17, 1989

Question 1. What are the possibilities for expanding electronic futures trading? Would such an expansion make it easier to create an audit trail on transactions in order to discourage fraud?

Answer. NYMEX has signed a Letter of Intent to join in the electronic order execution system currently being developed by the Chicago Mercantile Exchange and Reuters. NYMEX is optimistic that, at a minimum, electronic trading can expand access to U.S. futures markets by international participants at times when the U.S. exchanges are closed. NYMEX also has investigated, and will continue to consider, electronic enhancements to its audit trail creation, and may also consider small order execution systems to be employed concurrently with pit-trading. It is premature to comment on the likelihood of such systems becoming effective.

The audit trail in an electronic system may be better than the current audit trail in that, from the time an order is entered into a system until it is executed or canceled, there would be an unalterable record coupled with uniform timing capability. In the event that liquidity on an electronic system can match the liquidity on the trading floor, the improved audit trail may answer some regulatory questions.

Question 2. How effective do you think the Commodity Futures Trading Commission has been in regulating the futures markets? Senator Kerrey brought up the matter of unpaid CFTC fines—what could your exchanges do to help the CFTC collect these fines?

Answer. NYMEX believes that the Commodity Futures Trading Commission ("CFTC" or the "Commission") has been an effective regulator. The industry's growth over the last several years has been well documented and there are bound to be some adjustments required to the regulatory process. The fact that there have been prompt and detailed reviews of trading rules and practices by the CFTC and the exchanges over the past several months suggests that the regulatory structure is both responsive and committed. Any regulatory system has the potential that there may be some wrongdoers who temporarily avoid detection. However, the Exchange does not believe that fact is reason to assume that the entire regulatory structure—including both the exchanges and the CFTC—has been ineffective.

On the subject of civil monetary penalties assessed in CFTC enforcement actions, the Exchange can assist the Commission in the collection process. Under current rules, the CFTC has the authority to prohibit an individual or entity that fails to adhere to a Commission order from trading on or subject to the rules of a contract market. If NYMEX became aware that a member of the Exchange was subject to such a trading prohibition it would enforce the prohibition. Likewise, if an individual subject to such an order sought to become a member, it is it is certain that he would not be approved by the Exchange's Membership Committee or Board if the matter was known to them.

However, with respect to nonmembers (public traders, nonmember firms or nonmember firm employees), the Exchange has no financial or regulatory jurisdiction to assist the CFTC with collection. Furthermore, without seeing a breakdown of the uncollected penalties, one would assume that a substantial portion is owed by fringe firms that are no longer in existence or individuals no longer in the business. If that is the case, the fine may have already served the goal of deterring future violations by these persons or entities by driving them from the industry.

Question 3. How would you suggest that the CFTC oversee or regulate your self-regulation efforts? Are your newly installed computer procedures to allow transaction monitoring and auditing readily available to the CFTC for their own monitoring efforts? How compatible and comparable are the transaction monitoring systems in the different markets you represent?

Answer. The CFTC's current oversight authority and execution provide it with the ability to monitor the Exchange's self-regulatory effectiveness. The Commission conducts extensive, periodic rule enforcement reviews in all areas of the Exchange's surveillance and compliance operations—trade practice, market surveillance, financial surveillance, speculative position limits, audit trail, arbitration, etc. In addition, the Commission maintains a presence on the Exchange floor, reviews all Exchange rule amendments and proposals, reviews disciplinary actions and litigation, in addition to studying and proposing their own industry-wide regulations. NYMEX supports the Commission's efforts to obtain the appropriate financial and staffing budgets to enable it to continue to carry out these functions effectively.

NYMEX's computerized surveillance and compliance systems are uniform for all contracts traded at the Exchange. The CFTC has access to all of the Exchange's audit trail records under its current inspection powers and in practice. On a monthly basis, the Exchange provides computer tapes of its audit trail record—the Streetbook—to the CFTC. In addition, the Exchange provides the Streetbook information for any particular day requested by the Commission. Finally, while the Commission's own computer technology is extensive and continues to expand, the Exchange generates its own computerized surveillance runs on behalf of the Commission, when and as requested. Thus, the CFTC has access to all of the information and analytical tools used in surveillance and compliance efforts at the Exchange.

Question 4. The industry seems to be split on the question of banning so called dual trading where brokers trade for themselves as well as for customers. I would like each of you to state your position on this issue and describe what you think would be the practical consequences of banning dual trading? If you favor no restrictions on dual trading, how do you propose that your internal monitoring systems and those of the CFTC prevent possible abuse in these types of transactions?

Answer. The Exchange's Regulatory Review Task Force has taken the position that dual trading should not be restricted or eliminated, without further study on its effect on liquidity and market efficiency. Existing systems, including extensive trading rules, an accurate audit trail and effective surveillance and compliance programs, in addition to certain refinements recommended by the Task Force, should be sufficient to deter, detect and punish trade practice abuses. Accordingly, the Task Force recommended maintaining dual trading which has been an integral part of the Exchange's development into an efficient and effective forum for price discovery and risk shifting. The Task Force's Report and Recommendation containing a fuller exposition of its position on dual trading and the effectiveness of the Exchange's safeguards against abuse has previously been submitted to the Committee. For your convenience, an additional copy is enclosed.

COMMODITY EXCHANGE, INC.
FOUR WORLD TRADE CENTER,
NEW YORK, NY., *June 8, 1989.*

MS. BETSY PAUL,
Hearing Clerk, U.S. Senate Committee on Agriculture, Nutrition, and Forestry, Room 328A, Russell Senate Office Building, Washington, DC.

DEAR MS. PAUL: By correspondence of May 24, 1989, Senator Leahy forwarded to Comex a series of questions submitted for the record in association with testimony I provided to the Committee on Agriculture, Nutrition, and Forestry at its May 17, 1989 hearing. Pursuant to this request, enclosed are responses to inquiries submitted by Senators Leahy and Conrad for inclusion in the record.

Very truly yours,

ROBERT E. FINK,
First Vice Chairman.

Enclosures.

ANSWERS TO SENATOR LEAHY'S QUESTIONS

DUAL TRADING

Question 1. I understand that you agree with me that dual trading must exist side-by-side with an effective audit trail system, and that your exchange is or soon will be capable of maintaining a 90 percent audit trail accuracy rate. To guarantee the public that this standard is adhered to, is there any reason that Congress should not ban dual trading in any adequately liquid pit where, in fact, the exchange audit trail system fails to meet the 90 percent standard? Otherwise, we could not guarantee that abuses are being effectively policed.

I assume, for purposes of this question, that the judgment of which trading pits are adequately liquid would be made by the CFTC.

Answer. As I stated in my testimony before the Committee, Comex believes that it is imperative that the exchanges develop effective means of tracking the execution times and sequences of all transactions entered into on their trading floors to facilitate monitoring of the practices of each person involved in the execution flow of an order. I further acknowledged that 90 percent audit trail accuracy standard is achievable. Nonetheless, the enhancement of an exchange's audit trail program must be made a priority as a matter of self-regulatory policy, independent of the current debate concerning dual trading, and the failure of a particular exchange to achieve a quantifiably high standard should not result in the prohibition of dual trading, which would be detrimental to public investors.

Comex believes that dual trading significantly contributes to market liquidity in some circumstances, increases the flexibility of traders to deal with changing market conditions and results in better brokerage services to the public. Certainly, these are advantages to investors, which bear retention in the absence of strong evidence of unfettered abuse. While the public also derives benefits from an exchange's self-regulatory program, it is illogical to link the continued existence of services by which the public directly benefits, such as dual trading, with the exchanges' own obligations to monitor their markets. To make the investment community suffer the loss of dual trading because an exchange may be unable to enforce its own audit trail standards (which, in turn, are merely part of the measures used in an exchange's compliance efforts), inappropriately penalizes investors rather than the actual wrongdoers.

Your question appears to be premised upon the belief that adherence to a standard of audit trail accuracy necessarily leads to "effective policing" of wrongdoing. Comex would take issue with that assumption for it is our observation that absent a commitment by an exchange to utilize a variety of innovative investigative techniques and to sanction abuses once discovered, the reliance upon statistical adherence to what is, in effect, a recordkeeping device is misplaced.

Question 2. Please comment on whether you think the following proposals, which appeared in the April 19 report of the Chicago Mercantile Exchange special committee, should become industry standards:

(1) That floor compliance staff be authorized to inspect all trading floor documents, including customer orders and trading cards, immediately on the spot;

(2) That the so-called "fast market" designation, under which a broker's responsibility to fill his customer's orders is lessened during periods of high price volatility, be eliminated. In other words, brokers would be held to the same standard of care in executing customer orders no matter how fast the market is moving.

Answer. (1) Under Comex's rules, the Exchange's Compliance Department is given broad authority to initiate and conduct investigations of all members and member firms, without limitation as to the manner or time within which Compliance Department staff may inspect source documents germane to an investigation. Concomitantly, the Exchange's rules require each member and member firm to cooperate fully in all investigations and to comply with any request made by the Compliance Department, including requests for books, records and copies of documents. While we believe that these rules already authorize immediate inspection by the Compliance Department of all source documents relating to trades, we would not oppose an explicit industry standard incorporating these requirements.

(2) The second question you have posed, concerning brokers' responsibilities during "fast" markets, is somewhat more complicated to address. Comex's rules require a broker to exercise due diligence when executing customer orders. While our rules do not relieve the broker of this standard of care under any circumstance, the application of the "due diligence" standard when judging whether a broker acted properly does depend upon market conditions at the time the order became executable. Thus, a broker must always act with diligence, but diligence in a highly vola-

tile or "fast" market will often result in less predictable execution prices than would be experienced in a stable market. With that understanding in mind, in arbitrations concerning a broker's diligence, our rules expressly permit the entry into evidence of members' observations concerning the broker's exercise of care and the market conditions prevailing at the time the broker acted or failed to act in the ring so as to enable arbitrators to determine for themselves whether the order in dispute was properly handled.

In light of these comments, we can fairly support a uniform standard of care such as due diligence (that is, a level of liability short of "strict liability") to which a broker should be held for the execution of orders in his hand. Nonetheless, Comex believes that the application of the standard in a dispute resolution forum must continue to be left within the discretion of the triers of fact.

ANSWERS TO SENATOR CONRAD'S QUESTIONS

Question 1. What are the possibilities for expanding electronic futures trading? Would such an expansion make it easier to create an audit trail on transactions in order to discourage fraud?

Answer. To the best of our knowledge the current electronic futures trading initiatives would only be utilized during those hours when the applicable open outcry markets are closed and, therefore, would have no effect on regular hours audit trail mechanisms. While electronic futures trading presents some audit trail advantages, the full implications of such a system require further study. We are now evaluating the electronic initiatives to see which best meets our needs, with respect to providing a viable trading environment and adequate surveillance.

Question 2. How effective do you think the Commodity Futures Trading Commission has been in regulating the futures markets? Senator Kerrey brought up the matter of unpaid CFTC fines—what could your exchanges do to help the CFTC collect these fines?

Answer. We believe that, as the CFTC has gained increased understanding and appreciation for the markets under its jurisdiction, it has become a more effective regulator. This process continues.

While a "healthy friction" is probably desirable between the agency and the industry, we all have the same goal: a healthy, innovative U.S. futures industry in which participants can be confident of fair and honest treatment.

We are not in a position to fully respond to your second question, since we are unclear as to which types of fines Senator Kerrey referred. We would guess that these fines involved individuals and entities that are not members of any exchange, and relate in many cases to off-exchange transactions over which the exchanges would have no jurisdiction. If, however, the CFTC were to contact us regarding its inability to collect a fine from a Comex member or member firm, we would certainly cooperate to ensure that the fine were paid.

Question 3. How would you suggest that the CFTC oversee or regulate your self-regulation efforts? Are your newly installed computer procedures to allow transaction monitoring and auditing readily available to the CFTC for their own monitoring efforts? How compatible and comparable are the transaction monitoring systems in the different markets you represent?

Answer. In my testimony I referred to the surprising disparity revealed by comparative statistics dealing with the size of exchange compliance staffs, expenditures for compliance, and monetary sanctions against members. In my view, acceptable standards have to be established, understood and adhered to by all participants so that the performance of each exchange can be measured. In that regard, we believe the CFTC has an important role in developing and assuring the equitable application of that standard. Along our evolutionary self-regulatory path, the prodding and direction of the CFTC have been constructive and instrumental in improving our programs. Great strides have been made and continue under the existing regulatory framework. There does not appear to be a need for a fundamental restructuring of that framework.

All of our monitoring and auditing procedures are readily available to the CFTC upon request.

We use the same transaction monitoring in each of our markets: gold, silver, copper and aluminum.

Question 4. The industry seems to be split on the question of banning so called dual trading where brokers trade for themselves as well as for customers. I would like each of you to state your position on this issue and describe what you think would be the practical consequences of banning dual trading? If you favor no restrictions on dual trading, how do you propose that your internal monitoring systems and those of the CFTC prevent possible abuse in these types of transactions?

Answer. As an outgrowth of the attention focused upon potentially illegal trading practices on the exchanges, each exchange has pursued a course of self-examination to determine, among other things, whether trading activities such as dual trading should be permitted to continue. Proponents of a ban on dual trading argue that the public perceives that dual trading necessarily leads to abuses of customer orders and that the enhancement of the industry's image can only be achieved through implementation of a broad trading prohibition. Comex views this suggestion as a solution of expedience which does not address equally problematic aspects of trading abuse, while posing serious disadvantages to users of the markets.

The Special Advisory Panel appointed by Comex to study this issue concluded that dual trading provides significant benefits to the market in addition to liquidity. For example, the Panel observed that the presence of dual traders in a trading ring supplies flexibility which enables floor traders to respond to changing market conditions, *e.g.*, providing immediate additional brokerage capacity in a fast market, thus enhancing the efficiency of the market. This flexibility would be lost if dual trading were to be abolished.

The Panel also noted there is a consensus that dual traders provide better brokerage services because of their greater trading expertise and sensitivity to market forces and that the abolition of dual trading will increase the cost of brokerage services.

In the course of interviews which the Panel conducted of users of our market, *all* without exception stated that they used (and the substantial majority indicated that they sought out) dual traders for the execution of their orders, notwithstanding the potential conflict of interest dual trading presents. While not every interviewee was prepared to endorse dual trading unreservedly, not one interviewee articulated the view that the disadvantages of dual trading merited its abolition.

Trading ahead of a customer order, or "frontrunning"—the primary abuse of dual trading—has been prohibited for many years and is the most readily detectable abuse by a diligent compliance effort. Moreover, 7 years ago, in an effort to eliminate what was perceived to be the most common method of frontrunning, Comex adopted a rule, unlike any other exchange's, which prohibits floor members from trading opposite customer orders, either directly or indirectly. This prohibition applies not only to the floor broker executing the customer order but to any other member of the Exchange affiliated with the executing floor broker, whether through formal partnership or employment arrangements or through more informal or temporary means. The effect of this prohibition has been that a floor broker attempting to take the other side of a customer order, in conjunction with his trading ahead of that order, must engage in other trading abuses, such as prearranged trading with another member, which make that form of frontrunning more easily detected.

To uncover these types of activity, our Compliance Department utilizes a variety of reports generated by the Exchange's automated surveillance program and computer center, and undertook sometime ago to train its investigative staff to identify trading patterns which may evidence trading abuses.

The abolition of dual trading would eliminate only one means of trading abuse, direct frontrunning, but would not affect other trading abuses which disadvantage customers. Each of the other (also currently prohibited) methods of effecting similar results, such as withholding of customer orders and the disclosure of customer orders in exchange for profit-sharing—each an indirect form of frontrunning—would remain unaffected by the prohibition of dual trading.

The abolition of dual trading is thus unlikely to have a meaningful impact on many types of trading abuses. At the same time, the abolition of dual trading has the potential of rendering the markets more illiquid, less efficient and more expensive (although perhaps in certain markets more than others) without providing any material corresponding benefit.

Comex believes that the systems, rules, practices and procedures currently used to detect, investigate and sanction trading abuses are effective tools and establish an industry benchmark which we invite you to review. Of course, we continue to review and endeavor to improve our recordkeeping and surveillance programs, and we expect these improvements to enhance our ability to detect and deter trading abuses. Moreover, and perhaps more importantly, our disciplinary committees increasingly have evidenced their willingness to sanction wrongdoers in meaningful ways.

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